

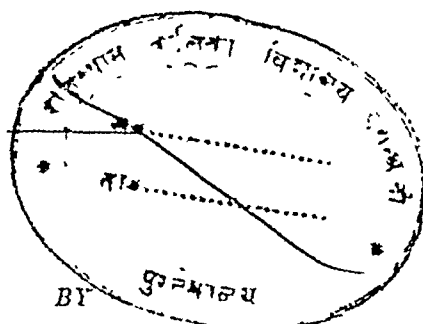


INTRODUCTION TO MONEY  
EXCHANGE  
AND  
BANKING



# INTRODUCTION TO MONEY EXCHANGE & BANKING

WITH  
SPECIAL REFERENCE TO INDIA



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## PREFACE TO THE FIRST EDITION

The first appearance of a book like this might demand a few words by way of justification. My long and intimate connection with the students of the University of Delhi made me realise the handicaps which they, in grasping the subtle and involved principles of currency and exchange, constantly laboured under. The market has already been glutted with numerous works on the subject some of which are undoubtedly excellent but most of the books extant in the market have been found inadequate for one or more of the following reasons. Either they are too restricted in scope and treat of one of these sub-subjects with the consequent narrowness of approach, or they are too difficult in language or their data and figures are not, at least in some important respects, the most up-to-date. The dearth of a single comprehensive book treating of the intricate problems of money, exchange and banking impelled me to make this maiden venture in authorship. It cannot be denied that the desideratum of a volume of this description dealing with the rudiments of currency and banking with suitable reference to Indian economic life has been long felt.

Economics has made great and rapid strides of late but the complexity of the subject has compelled its full results to be unexplored and unmeasured. Interest in banking and currency has perhaps never been more vital than it is to-day. Even in India, conditions have changed appreciably and fast since the Report of the Banking Enquiry Committee, the enactment of the Reserve Bank Act and the consequent inauguration this year of

the Reserve Bank which is destined to play an important part in the future of Indian currency, exchange and banking.

Since the subject of currency is in perpetual flux and reflux, students are obsessed with its problems so much so that sometimes they have been found to have made 'confusion worse confounded.' I have, therefore, strained every nerve to facilitate students' apprehension of the principles and problems of currency. My prime objective has been to elucidate the intricate problems and principles of currency with copious, familiar and forceful illustrative references. In fact, to present this subject-matter in a logical, ordered and pellucid sequence has alone been the *raison d'être* of the publication of this book.

I must apologise in advance if some of my junior readers find the language a little stiff at places. Obviously, in a discussion of such complicated and abstruse a subject as this, a certain amount of technicality could not be avoided with the best will in the world to do so. Every effort has, however, been made to keep down the number of expressions not intelligible at a glance and it is hoped that they are no more than the irreducible minimum. Even those who feel this difficulty will find it vanishing fast after a close reading of the first few chapters.

An attempt has been made to make the book comprehensive so that it will be found to cover the syllabus of many universities of Northern India and it is confidently hoped that it will serve as a *vade mecum* to all students of Economics, particularly those grappling with the terse problems of currency and banking. To render the book an

## PREFACE

auxiliary vehicle for the students in mastering the subject, succinct but comprehensive summaries have been appended to each of the chapters. Questions of varied types, culled with care from the examination papers of various universities, have been incorporated in the body of the book with the evident purpose that students might consult them and derive benefit especially at a time when they are revising or trying to refresh their memories in a hurry. I shall consider my pains amply rewarded if the book will prove to be of some assistance to students in grasping the complexity of the subject in a clearer focus.

I take this opportunity of thanking kind friends and all those who have helped me in one way or the other. Foremost of these should be mentioned Mr. K.C. Nag, Reader and Head of the Department of Economics at the University of Delhi, Mr. Hirde Narain, Head of the Department of Economics, Hindu College, and Mr. B. N. Ganguli, Reader in Economics. To Prof. Nag's constant encouragement and kind attention I owe and shall always owe much; Prof. Hirde Narain and Prof. B. N. Ganguli have very kindly looked at the manuscript and given valuable suggestions from time to time. Mr. M. A. Jan, Librarian of the Imperial Secretariat Library, has been kind enough to offer me facilities of all kinds. His unfailing courtesy and indefatigable assistance are unforgettable. Lastly, Mr. Loke Ram Sharma, B.A., has been of great help to me in preparing the Index. I sincerely and cordially offer my thanks to all of these gentlemen.

Any constructive criticisms and suggestions conducive to the improvement of the book either in respect of the plan or scope or matter will be heartily welcome and appreciated.

In fine, I would like to express myself in the immortal couplet of the poet :—

“And what is writ is writ,—  
Would it were worthier !” (Byron)

RAJ NARAIN MATHUR.

Hindu College, Delhi,  
*2nd December, 1935.*

## PREFACE TO THE FOURTH EDITION

The present War has had far-reaching effects on the currency and prices in India. Some of these effects have been traced in Chapter XIII, which has been introduced for the first time, while others have been discussed in Chapter XVI. Chapter XVI has been further enlarged by the addition of a critical estimate of the achievements of the Reserve Bank of India and a fairly comprehensive study of the problems of rural and industrial finance which are attracting a good deal of public attention now-a-days. On account of the abandonment of the Gold Standard and the consequent adoption of artificial monetary systems by the leading nations of Europe, the problem of exchange control has become particularly important. Chapter VIII has, therefore, been suitably amended so as to bring out the importance and the mechanism of exchange control operations. In other respects also the statistics and other illustrative data have been brought up-to-date and it is hoped that, in its present form, the book would prove even more useful to those for whom it is intended.

I wish to express my grateful thanks to my colleagues, Dr. B. N. Ganguli and Mr. N. K. Bhojwani

both of whom have added one more to my many obligations to them by kindly reading through the manuscript and making a number of very valuable suggestions.

RAJ NARAIN MATHUR.

Hindu College, Delhi,  
*June, 1941.*



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# INTRODUCTION TO MONEY, EXCHANGE AND BANKING WITH SPECIAL REFERENCE TO INDIA

## CHAPTER I

### THE MECHANISM OF EXCHANGE

**Definition of Barter.** In primitive states of society wants are few and easily satisfied. Every body produces just what he requires, but if he produces more, he can easily exchange it with the surplus product of another man's labour. This system of exchange of commodities for commodities or services is called '*Barter*.'

**Defects of Barter.** As wants increase, however, and new methods of satisfying them are discovered, barter becomes a very inconvenient process—quite unsuited to a civilised society based on complex division of labour. Barter is in the nature of a double act which pre-supposes agreement between two individuals. When the number of exchangeable goods increases, it becomes less likely that a case should arise of the meeting of two people each of whom has a superfluity of *just those goods* of which the other stands in need. For example, a man with a horse and wanting a coat may never get it unless he finds somebody who is prepared to give him a coat *and* accept his horse in return. Even if two people could be found whose disposable possessions mutually suit each other, in the absence of a common measure of value, at what rate is one commodity to be exchanged for another? It is highly improbable that the owner of the horse would regard it as exactly equivalent to the coat, and if he

thinks that his property is more valuable, exchange would be clearly impossible because a portion of the horse would be of no use to the owner of the coat. Hence, three inconveniences attach to the practice of simple barter, namely, the improbability of coincidence between persons wanting and possessing, the complexity of exchanges which are not made in terms of one single substance, and the need of some means of dividing and distributing valuable articles.

**Origin of Money.** In order to avoid these difficulties of barter it is necessary to decide upon an *intermediate* commodity which would always be accepted in exchange for goods and services and which would form a basis for the measurement and comparison of the values of all other commodities. Such a commodity is called 'Money.' It may be defined as "anything which is widely accepted in payment for goods or in discharge of other kinds of business obligations."<sup>1</sup> Marshall has defined money as "All those things which are (at any time and place) generally current without doubt or special enquiry as a means of purchasing commodities and services and of defraying expenses."<sup>2</sup> Cole has recently defined money simply as purchasing power—something which buys things.<sup>3</sup> This definition is, however, too inclusive. It includes even the media of exchange which have a very narrow area of circulation and which may be refused e. g. cheques and bills of exchange. Such instruments which are not generally acceptable should not be called money. Money is included in the term medium of exchange but all media of exchange are not necessarily money.

1 Robertson—*Money*—pp. 2-3.

2 *Money, Credit and Commerce*—p. 13.

3 G. D. H. Cole—*What Everybody Wants to Know About Money*—p. 21. For a still more illuminating discussion of the meaning of money read—*Johnson—Money and Currency*—pp. 6-7.

**Functions of Money.** Money performs a four-fold function. It is, in the first instance, a *medium of exchange*. It enables a person to *buy* and *sell* directly what he wants. He parts with money when purchasing and gets money when selling goods and services. A careful study of the evolution of money will show clearly that the primary cause of the creation of money was the necessity of overcoming the great difficulties of direct exchange or barter—difficulties which grew progressively as the exchangeable commodities increased in number. Historically, therefore, to act as a general medium of exchange appears to be not only an essential function but the *only* essential one and other functions as having been derived from it. Secondly, it serves as a *common means of payment* because people accept it without hesitation in the hope that others will take it in turn. Thirdly, it is a *common measure of value*, or strictly speaking, a *common denominator* of relative values. Thus it avoids the difficulty of remembering the cross-relationships of millions of articles of varying quality and fineness. If, for example, we know that wheat sells at Rs. 6 a maund, corn at Rs. 3 and straw at Rs. 2 a maund, we know that the value of wheat is twice that of corn and thrice that of the straw. Every article bought or sold can now be valued in terms of the common unit and the value of the commodity measured in terms of money constitutes its *price*. Fourthly, it serves as a *standard of deferred payments*. Contracts, including loans, are usually made in terms of money. This is because people believe that the value or purchasing price of money is not likely to change much during the period of the contract. If there were no money, lending of all kinds would be much restricted owing to the risk that the value of the commodity in terms of which the loan was made would change considerably. Lastly, it is a



means of storing value.<sup>1</sup> Perishable commodities cannot be stored as they lose in value with time. Storing of bulky commodities is also difficult. With the introduction of money one can transform his savings in money and with money he can readily purchase both goods and services. Thus "it subdivides and distributes property and lubricates the action of exchange."<sup>2</sup> It may perhaps be easier to remember the functions of money by the following rhyme :—

"Money's matter of functions four,  
A medium, a measure, a standard and a store."

Now, it should be quite possible to use one substance as a medium of exchange, a second as a measure of value, a third as a standard of value and a fourth as a store of value. "In buying and selling we might transfer portions of gold; in expressing and calculating prices we might speak in terms of silver; when we wanted to make long leases we might define the rent in terms of wheat, and when we wished to carry our riches away, we might condense it into the form of precious stones." But it is obviously convenient to select a single substance to perform all the functions of money.

**Characteristics of Good Money.** We have seen that money is a visible assurance that a claim upon the society will be duly honoured. We take money for our goods and services because we are convinced that others will take it from us in return for their goods and services. Anything with regard to which we have this conviction is money. It may be a piece of metal bearing the stamp of public authority or merely a written

1 Benham has used the phrase "a liquid asset" instead of "a store of value". See his *Economics*—pp. 337 and 341.

2 Jevons—*Money and the Mechanism of Exchange*—p. 15.

promise to pay an equivalent amount of metal or any other suitable substitute. Primitive societies probably used crude implements of stone and metal as money but instances are not rare when slaves, oxen, sheep, rings, shells, skins etc.,<sup>1</sup> were used and are still being used as medium of exchange. In advanced communities, however, these crude articles have been replaced by precious metals. They possess utility and value. "Nothing which is not itself valuable can serve as a medium of exchange. No one would consciously give away commodities of value for a medium of exchange which was notoriously lacking in value and which he might possibly be obliged to hold for a time. Otherwise, the whole purpose of exchange would be defeated, since for a worthless medium of exchange one could not obtain other goods".<sup>2</sup> Their beauty and their quality of being easily fashioned make them universally desirable as raw material for ornaments and for other articles of all kinds, quite apart from any question as to their utility. They are durable, that is, possess an almost unlimited power of resistance to the destructive influence of water, air, fire etc. This quality enables them to be easily stored for any length of time without risk of change in their substance. The composition of the precious metals is absolutely uniform. It does not vary from piece to piece and is

1 Schurtz quotes from Mollien's book on his journeys in the interior of Africa the following table of values for Bondu in Western Sudan :

- 1 slave=1 double-baralled gun and two bottles of powder.
- " " =5 oxen.
- " " =100 pieces of cloth.
- 1 string of glass beads=1 gourd bottle of water.
- " " " " " =1 measure of milk.
- " " " " " =1 armful of hay.
- " " " " " =1 measure of millet.

See Helfferich's "*Money*" Vol. 1, page 9.

2 Laughlin—*The Principles of Money*—p. 18.

independent of the place of origin. The homogeneity of precious metals affords complete protection against the circulation of false coins. A still further important quality of the precious metals which is essential to their function as money is their unlimited *divisibility*. They can be divided with exactness into smaller parts and can again be melted together into a whole at a small cost. Thus there is no limit to the magnitude of the values which can be represented by the precious metals in contrast with commodities such as shoes and cattle which are, by nature, indivisible or with commodities which can only be divided with loss of value as is the case of diamonds. The *malleability* of precious metals renders them particularly adaptable to take impressions and this makes it possible for individual pieces to be authoritatively certified in regard to their fineness and weight. The precious metals are comparatively *scarce*. Their *large value in small bulk* contributes to the easy transfer of money from place to place and gives it a substantially uniform value in all parts of the world at the same time. Finally, we must mention that especially important property of precious metals—relative *stability of value*—which follows from some of the properties mentioned already. Their value is normally free from fluctuations caused by excess or shortage of supply and from destruction through wear and tear.

Some of the qualities enumerated above can be met with in other commodities in an equal or even higher degree. For example, diamonds possess high intrinsic value but they are more destructible and very much less plastic than the precious metals. It has so far been found possible to make small diamonds out of large ones but not one large diamond out of a number of small ones. Such a happy and complete combination of these qualities

is to be found in gold and silver that one is not surprised that they constitute universal money independently of all conventions and law.

**Advantages of Money.** In modern civilised society inconveniences of the primitive method of exchange are wholly unknown and might almost seem to be imaginary. The modern economic system is founded on the principle of production for a market. Division of labour has caused a wide gulf between the products of the individual's labour and his requirements. Money alone makes possible the exchange of goods and services in the degree required by our economic system and has, therefore, forced barter very much into the back-ground. From the entrepreneur down to the smallest peasant farmer, all sell their surplus products for money. The workman places his labour at the disposal of the employer for a money wage; the transfer of wealth and purchasing power takes place in money. Money increases production by facilitating exchange of commodities by promoting specialisation. It gives necessary mobility to capital and thus helps the concentration of capital in the hands of those who are best able to utilise it in an effective manner. It makes capital flow from places where it is less productive to places where it can be employed profitably. It has been responsible for the growth of social and political freedom by substituting freedom of contract and competition for custom and status. It has also broken up the exclusiveness and isolation of towns and villages, and has thus created national and political solidarity. In short, in the whole process of production and distribution, money enters as a connecting medium between the different members of a society and between different communities. "Accustomed from our earliest years to the use of money, we are unconscious of the inestimable

benefits which it confers upon us; and only when we recur to altogether different states of society can we realise the difficulties which arise in its absence."<sup>1</sup> It is interesting to note in this connection that the service of money to society is similar in character to that of the roads and other means of communication. This fact was pointed out by Adam Smith when he declared: "The gold and silver money, which circulates in any one country may very properly be compared to a highway which, while it circulates and carries to market all the grass and corn of the country produces not a single pile of either."<sup>2</sup>

It should not be imagined, however, that barter is totally extinct now-a-days. It still goes on in some cases even in the most advanced commercial countries but only when its inconveniences are not experienced. Domestic servants receive part of their wages in board and lodging; the farm labourers may partially receive payment in kind or the use of a piece of land. In a large majority of transactions, money intervenes in one way or the other and, even when it does not pass from hand to hand, it serves as the measure by which the amounts given and received are estimated.

1 Jevons—*Money and the Mechanism of Exchange*—p. 2.

2 Robertson explains the advantages of money thus: "It enables man as consumer to generalise his purchasing power, and to make his claims on society in the form which suits him most. The existence of a monetary economy helps society to discover what people want and how much they want it, and so to decide what shall be produced, and in what quantities, and to make the best use of its limited productive power...It helps each member of society to ensure that the *means* of enjoyment to which he has access yield him the greatest amount of *actual* satisfaction which is within his reach...It gives him the chance of not surfeiting himself with bus rides, or stinting himself unduly of the countenance of Charlie Chaplain...It enables a man as producer to concentrate his attention on his own job and so to add more effectively to the general flow of goods and services which constitute the real income of society. The existence of money...seems to be a necessary condition for any great development of the division of labour." *Money*—pp. 5-8.

**Evils of Money Economy.** Nevertheless, there are various dangers associated with the use of money. It makes it easy to lend and borrow things which sometimes proves detrimental to the best interests of the society. The value of money, moreover, as we shall see presently (Chapter VI) does not always remain stable. Its power to purchase goods and services changes from time to time thereby prejudicing one section of the community against the other, and, if these fluctuations are rather wide, crippling trade and industry altogether. It produces inequalities in the distribution of income and thus leads to the concentration of wealth into the hands of capitalistic classes. It is also responsible for the modern system of wages which is highly injurious to the labouring classes.

It is true that some of these evils are inherent in the use of money and must be tolerated as the price which the society must pay for the multifarious advantages which it derives from its use. Other evils can be removed and to the extent that they can be removed the general interests of mankind require that they should be tackled in the right spirit.

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### SUMMARY

**Definition of Barter.** Exchange of commodities for commodities or services is called Barter.

**Defects of Barter.** (i) Lack of double coincidence of wants.

(ii) Want of a measure of value.

(iii) Want of means of sub-division.

**Meaning of Money.** Money is nothing but an intermediate commodity designed to remove the defects of Barter, or simply, a purchasing power—something which buys things, and is universally acceptable.

**Functions of Money.** "Money's a matter of functions four; A medium, a measure, a standard and a store."

It is possible to use different substances for performing each of these four functions but it is convenient to select a single substance to perform all the functions of money.

**Characteristics of Good Money.** Many articles were tried as money but most of them were abandoned because they did not possess many of the following essential qualities:—

- (i) Utility and value.
- (ii) Beauty.
- (iii) Universal Desirability.
- (iv) Durability.
- (v) Homogeneity.
- (vi) Divisibility.
- (vii) Malleability.
- (viii) Stability of value.

The only two metals that possess these qualifications in a more or less degree are gold and silver and they constitute universal money independently of all conventions and law.

**Advantages of Money Economy.** It is ideally suited to the modern economic organization based on large scale production and division of labour. It helps the sale and purchase of goods and services and measures amounts given and received

**Evils of Money Economy.** It makes it easier to borrow and lend money with all their evil effects. The value of money does not always remain stable and thus, at times, proves harmful to people, trade and industry.

### QUESTIONS

1. Explain the conditions in which barter is possible. Why does sale for money take the place of barter?

[U. P. Board Inter. 1926 and Delhi Inter. 1929].

2. Define money. What functions are performed by money at the present time?

[U. P. Board Inter. 1933 and Delhi Inter. 1930]

3. What are the characteristics of good money?

[Delhi Int. 1928.]

4. Write short notes on:—

(a) Inconvenience of Barter.

[Agra B. A. 1934 and 1935]

(b) Barter Economy and Money Economy.

[U. P. Inter. 1934]

## CHAPTER II

### FORMS OF MONEY<sup>1</sup>

Money is generally classified as (1) Metallic Money, and (2) Paper Money.

**Metallic Money.** It consists of coins of metals like gold, silver, copper and aluminium and their alloys etc., appropriately stamped so as to make known their denomination and value.

**Coinage. Free, Limited and Gratuitous Coinage.** When gold and silver were first used as money they were lumps or bars of metal shaped into rings, discs and roughly cut pieces. No attempt was made to so fashion the metal that its weight could not be altered without destroying the shape and design. All payments had to be made by weight and the metal had to be frequently assayed or tested to see that it was of the required purity. In order to secure uniformity in coins of the same kind, convenience of shape, size and weight, and to prevent counterfeiting, the modern coins are properly stamped on either side and their edges milled to prevent clipping. This process of manufacturing metallic money is called coinage.<sup>2</sup> Coinage is said to be *free* if the public is allowed to offer bullion for being converted into coins ; it is called *limited* when coinage is done on government account only. The coinage of England, until

1 For an advanced study of the subject read Keynes—*A Treatise on Money*, Chapter II.

2 Jevons has defined coins as “Ingots of which the weight and fineness are certified by the integrity of design impressed upon the surfaces of the metal.”—*Money and the Mechanism of Exchange*—p. 57.



recently, was free while the coinage in India, ever since 1893, has been limited. In the U. S. A. coinage of gold is free and unlimited. People are permitted to take to the mint any amount of gold bullion in excess of \$100 and either have it coined or receive any other kind of money for it. On the other hand, the coinage of silver subsidiary coins is limited. Individuals are not free to take silver bullion to the mint. When there is need for additional subsidiary coins the Government buys the required metal in the market at the market price. In a system of free coinage, if no fee is charged by the government for the work of minting, the coinage is called *gratuitous*. It will exist where it is intended that the coin should be identical in value with an equal quantity of gold bullion so that it shall be so much certified bullion and shall be re-convertible into ingots without loss.

**Brassage, Seigniorage and Debasement.** If the government takes out of the coin an amount of metal equal to the cost of coinage, this deduction is called *brassage*. If a fee larger than the cost of coinage is charged, the difference between the amount thus taken out and the cost of minting is called *seigniorage*. Brassage refers to the charge made by the mint to cover such items of cost as assaying the bullion, alloy etc. Seigniorage means an extra charge for revenue or for profit made by the state in view of its internal monopoly of manufacturing coins. When a coin contains less than the standard amount of precious metals the difference between standard and real value is called *debasement*.

The disadvantage of gratuitous coinage is that coins minted the one day may be melted down the next or long before they are worn out.

Some people may find it less troublesome, at times even more profitable, (as during the Great War in India) to melt coins than to purchase bullion if the coin contains just about as much bullion as it will buy. On the other hand, if a country on a gold standard charges seigniorage for coining, then its coins are not perfectly inter-convertible with gold bullion and public confidence is rudely shaken. If coinage is not gratuitous, the bullion value of a coin is of course less than its face value and the melting of coins is consequently discouraged. This is why the Indian Rupee, which was open to free mintage in the beginning, ceased to be so after 1893.

**Natural and Token Coins.** Some coins are natural or full-bodied, that is, the value printed on them (or their face value) is equal to the value of the metal contained in them (or their intrinsic<sup>1</sup> value). The coins whose face value is higher by law than their intrinsic value are called token coins. Token coins are ordinarily of smaller denomination than the monetary unit and their purpose is to facilitate payments of small amount. They are usually made of silver and other baser metals such as copper, nickle, or bronze. Such coins may circulate freely at their face value in the country of origin but would not be accepted in other countries except at their metallic value. Hence their use is restricted to payments arising out of internal transactions only.

**Standard Coins.** Natural coins, on the other hand, serve as standard coins. They constitute, wherever they exist, the principal or ultimate

<sup>1</sup> Jevons discards the word "intrinsic" as being ambiguous in favour of "metallic" value to distinguish it from the "nominal", "customary", or "legal" value, at which a coin actually does, or is by law required to, exchange for other coins—*Op. Cit* p. 75.

means of payment both within the country and outside and the value of the token coins is fixed with reference to them. Although a standard coin is one of which the value-in-exchange depends solely upon the metal contained in it, it is not necessary that it should always be a full-bodied coin. A token coin may sometimes act as a standard coin as, for example, the Indian Rupee is a token coin and yet the values of all other kinds of money are adjusted to it. It has, therefore, been called a *standard-token coin*. It is useless for external payments because it may not be exported to countries where it is not legally current.

**Legal Tender—Limited and Unlimited.** Natural coins are easily accepted by the people because of their value as metal but token coins are not accepted quite as readily unless they are made legal tender by the government. Legal means 'by law' and tender means 'to give'. Any currency (metallic or paper) which a debtor may give in settlement of dues owing to him or any kind of money which, according to law, must be accepted when offered in payment of any obligation expressed in terms of the country's monetary unit is called *legal tender*. Token coins which are generally intended for transactions of smaller value are legal tender up to a certain extent only as shillings in England are legal tender up to 40 shillings or the Indian 4-anna, 2-anna, or 1-anna pieces which are legal tender up to Rs. 10. A standard coin, even in those exceptional cases when its intrinsic value falls far short of its face value (as in India), is always an unlimited legal tender. Similarly, the notes of the Reserve Bank of India are unlimited legal tender all over British India.

It must be clearly understood that the legal

tender law has nothing to do with contracts or other obligations not payable in money. Neither does it apply to contracts which, by their terms, are payable in any particular kind of money.<sup>1</sup>

**Paper Money—Its uses.** In order to save precious metals from wear and tear and to preserve them for purposes of art, paper money has been invented. It is *easier to handle* and *safer, cheaper*, and *more convenient* for making payments in distant places than metallic money. It also helps the government, when its credit is low, to raise necessary funds with less cost than it would have to pay if it resorted to borrowing.<sup>2</sup>

**Kinds of Paper Money.** There are three kinds of paper money :—

1. *Representative Paper Money.* It derives its value not from the paper on which it is printed but from the standard coins for which it can be exchanged. It represents an equivalent amount of metallic money deposited in the strong-room of a bank or of a national Treasury. The American gold and silver certificates guaranteed by gold and silver deposits in the Treasury of the United States or the Gold Bullion Certificates recommended by the Royal Commission on Indian Currency and

<sup>1</sup> It will perhaps not be out of place here to make a distinction between "the unit of currency" and "the unit of account". The former is legal tender while the latter is not. "The monetary unit for purposes of calculation is called 'the unit of account'". Normally the unit of currency and the unit of account are the same, for clearly the use of money as a measure of value springs from its use as a medium of exchange. It is possible, however, for the two units to be different, provided that an exchange ratio between them can be somehow established. Thus in Germany in 1923, when prices were rising very rapidly, contracts were often made in terms of Swiss francs or United States dollars. When the time for payment arrived, the payment was made in marks, the number of marks given being the number required to equal the specified sum of francs or dollars at the rate ruling at the time in the foreign exchange market. The mark remained the unit of currency but the unit of account was the franc or the dollar". Benham—*Economics*, p. 340.

<sup>2</sup> Also see Inflation and its effects at the end of Chapter VI.

Finance for India in 1927 are good examples of this kind of paper money.

2. *Fiduciary Paper Money*. This consists of notes for which specie can be had on demand. As all the note-holders are not likely to present notes for conversion at the same time, the amount of metal kept in the reserves is much less than the face value of the notes issued—the rest being backed by securities. The security portion of the reserve is called the *fiduciary or the invested portion*. Fiduciary paper money is not intended primarily to serve as a substitute for coin as is true of the representative type. Its purpose is rather to supplement the metallic money and to expand the total volume of the currency. To the extent that the fiduciary paper money is not backed by a reserve of 100 per cent it is equivalent to a loan to the government without interest.<sup>1</sup>

3. *Fiat Money*. It represents nothing and confers a claim to nothing. It is pressed into service when the government is hard-pressed for money. The most important instances of such money are the Greenbacks issued by the American Government during the Civil War, the French Assignats issued by the Revolutionary Government of France in 1789 and the Bank of England notes issued during the Napoleonic Wars. In the Great War of 1914-19, all the European countries made their notes inconvertible. In order to bolster up its value fiat money is, as a rule, made legal tender for all public and private debts. Since it amounts to direct taxation of the people without their consent, this kind of money is generally unpopular and frequently circulates at a considerable discount. The Rs. 2½ and Re. 1 notes, which were issued by the Government of India during the War, belonged to this category.

1 See also Keynes—*A Tract on Monetary Reforms*.

**Evils of Paper Money.** The paper money suffers from various defects. Its value is *precarious* because it is dependent on the will of the legislator or upon the solvency of the issuing bank. Should the law demonetise paper money or repudiate it, the holder will have in his possession nothing but bits of paper because when paper has lost its legal recognition it has lost all. Secondly, its value is more *restricted*, that is to say, its circulation is limited to a *narrower area* than metallic money. As a note derives its value from the law of a particular nation it cannot be expected to circulate beyond the boundaries of that nation. Thirdly, its value is more *changeable* than that of metallic money for the simple reason that the quantity of paper money mostly depends on the will of the government or the issuing bank.

The difference between the amount of notes issued and that of the metallic reserve is invested in securities so as to earn interest but the use of paper money in excess of the specie reserve means to the government or the bank so much purchasing power created out of nothing. This process, when taken to its logical conclusion, leads to inflation<sup>1</sup> with its attendant evils, viz., rise of prices and loss of purchasing power. It strikes hardest the poor and the ignorant and thus makes the burden of taxation very heavy. It encourages speculation of the worst type. The business community is demoralised. Security, steadiness and sound business give place to gambling and the desire to get-rich-quick spells disaster for a good many. The excessive issue of fiat money puts a premium on gold and that leads to the flight of metallic money and a sharp decline in the rate of exchange. Not infrequently we have the curious spectacle of duplicity of prices. Each commodity

<sup>1</sup> See end of Chapter VI.

has two prices—one payable in metallic money and the other in paper, the difference between them depending on the depreciation in the value of paper money. That is why some economists have gone so far as to say that the paper money is the “greatest plague of nations and that it is more injurious to society than a terrible disease is to an individual”.<sup>1</sup> It must be noted, however, that the evil effects are due rather to the imprudence of governments and banks than to the nature of paper money itself.

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### SUMMARY

**Forms of Money.** Money is classified as (a) Metallic and (b) Paper Money.

**Metallic Money**—is made up of coins of different metals properly shaped and stamped to prevent counterfeiting. Coins are manufactured (or coined) by the government. If the public is allowed to offer bullion for being converted into coin the coinage is said to be *free* otherwise *limited*. The coinage of India was free before 1893 and has been limited since. If no fee is charged for minting, the coinage is called *gratuitous* but if a fee equal to the cost of minting is charged it is called *brassage*. If a fee larger than the cost of coinage is charged, the difference between the amount thus taken out and the cost of minting is called *seigniorage*. The difference between the standard and actual (real) amount of metal contained in a coin is called *debasement*. A *natural* coin is one whose face value (*i. e.* value printed on it) is equal to its intrinsic value (*i. e.* value of the metal contained in it); a *token* coin is one whose face value is higher by law than the value of its metallic contents. Natural or full-bodied coins are used as standard coins, that is, for measuring the values of all other coins, goods and services; while token coins are used for payments involving fractional payments. When a token coin acts also as standard coin (as in India) it is called *Standard Token Coin*. Natural coins are unhesitatingly accepted because of their intrinsic value but token coins circulate by the force of law behind them. Coins (and paper notes) which people are required by law to accept up to

<sup>1</sup> Gide—*Political Economy*—p. 270.

any amount are called *unlimited legal tender* (e.g. Sovereigns); coins (and paper notes) which people may accept up to a certain amount only are called *limited legal tender* (shillings in England and small coins in India). A standard-token coin is generally unlimited legal tender (e.g. the Indian Rupee).

**Paper Money.** It saves precious metals (which it displaces) from wear and tear and is easier to handle, safer, cheaper and more convenient especially for making big payments and in distant places. It enables governments in difficult times to get more money without much cost. There are three kinds of paper money—(a) *Representative Paper Money*, which is fully backed by gold and/or silver coins and bullion and is thus the safest; (b) *Fiduciary Paper Money*, which is backed partly by metal and partly by securities but which can be got converted into metal at the will of the holder; and (c) *Fiat Money*, which is not covered by metal and does not carry any obligation on the part of the issuing authority to convert into anything. This is the worst and would not be tolerated by the public except under abnormal circumstances.

#### Evils of Paper Money.

1. Its value is precarious;
2. Its circulation is restricted to a narrower area; and
3. Its value is changeable. When over-issued, it leads to inflation and rise of prices.

#### QUESTIONS

1. Classify the various forms of money in circulation in the country and indicate the characteristics of each.

[Punjab B. A. 1932].

2. Explain the following terms :—

Token money, free coinage, gratuitous coinage, seigniorage, standard coins and legal tender.

[Delhi Inter. 1933].

3. Can token money be legal tender? What constitutes legal tender in India?

[U. P. Board Inter. 1929].

4. How does the rupee, though unlimited legal tender, fail to satisfy all the conditions of standard money?

[Delhi Inter. 1928].

5. The rupee may be called a 'standard-token' coin. Explain.

[Delhi Inter. 1929].

6. What are the characteristics of paper money? Why is it preferred to metallic money?



## CHAPTER III

### FORMS OF MONEY—(*Continued*)

#### SOME PROBLEMS OF PAPER MONEY

**Elasticity of Paper Currency.** In order to guard against the evils resulting from over-issue (and sometimes under-issue) of notes, it is necessary to make their amount conform to the requirements of trade. Their circulation should increase in the busy season and decrease in the slack season. This is not always possible. No one can import or export notes like coins and no one but the government or bank authorised by the government can issue or cancel them. Hence, if trade becomes brisk, nothing but a decree of the government can supply the requisite increase of circulating medium and if more money is put into circulation and trade relapses into dullness, the currency becomes superfluous and falls in value. This power of notes to adjust their volume to the need for currency is called *elasticity*. Dunbar has defined elasticity "as responsiveness to present increase or diminution of demand—the power of adaptation to the needs of the month, the week, or the day whether rising or falling."<sup>1</sup> The elasticity of currency is of special interest to India where the demand for currency varies from season to season and where cheque currency is less popular than elsewhere.

**Mobility of Paper Currency.** Just as the volume of currency should be altered to suit the

<sup>1</sup> *Economic Essays*—p. 238.

varying requirements of trade, it should also be capable of being transferred from centres where it is not needed to those where it is urgently required. The capacity of note-issue of being moved from place to place may be called *mobility*.

**Government *versus* Bank Note Issue.** It is an open secret that even the best informed government departments cannot be trusted to judge wisely and impartially when and where more money is wanted or when or from where superfluous currency ought to be pumped out. It is usually out of *direct* touch with trade and industry and is 'not as sensitive as a bank to the conditions in the financial and commercial world.'<sup>1</sup> The government's difficulty may be greater "in an emergency when businessmen have very urgent need of cash because the government mechanism is a slow but cautious process and is not readily responsive to sudden changes. A government whose primary duty is to look to the security of the currency system is naturally forced to study the problem that arises patiently and thoroughly with the result that some time elapses before any action is taken and the emergency demand may go unsatisfied. It may, therefore, happen that at times the supply of currency is less than its demand, *viz.*, there is stringency of money, or that the supply exceeds the demand *viz.*, there is over-issue of money."<sup>2</sup> Moreover, if the power of issuing notes is entrusted to the government, there is a danger of the true economic interests being sacrificed for the sake of political considerations and financial needs of the state. A party in power may issue huge quantities of notes just

1 Kisch and Elkin—*The Central Banks*, p. 73.

2 Dadachanji—*A Reserve Bank for India and the Money Market*, p. 18.

to serve its own ends and may even *create*<sup>1</sup> securities to satisfy its own legal conscience. The bank note-issue is free from these defects. A bank is constantly in touch with producers and businessmen and is thus in a better position to appreciate the needs of the market from time to time. It has a control over credit money (like bills of exchange, etc.<sup>2</sup>) which it can profitably utilise to accomplish what metallic and paper money alone would fail to achieve, namely, adjusting the volume of currency to *temporary* and *seasonal* requirements of trade and commerce. It is not concerned with party politics nor is its policy deflected by deficit budgets or military expeditions etc. The amount of note-issue is regulated by specific laws which definitely specify the proportions of gold and securities to be put in reserves. Any departure would at once be set right by the force of public opinion and government authority.

**Single versus Multiple Note-issue.** Having decided that the note-issue should be entrusted to a bank (rather than to the government) it remains to be seen whether it would be expedient to extend this privilege only to one bank or to all (or many) banks of the country. In the interest of controlling currency and credit effectively, centralisation is clearly the best. It ensures a proper degree of *elasticity* and *mobility* unhindered by conflicting policies that may be pursued by different institutions. It also means centralised reserves which are more economical and easier to mobilize especially in times of grave national emergencies. Ordinary commercial

1 Such securities are called "created" or "ad hoc" securities which (in India) are nothing but treasury bills issued by Government to itself. Until lately, the currency notes in India were issued by Government against its own I. O. U's. See Kale—*Indian Economics*, pp. 529-30.

2 See Chapter IV.

banks are chiefly guided by profiteering considerations and the tendency among them to compete for increasing their gains from this source may result in reducing the metallic portion to the minimum and in swelling the volume of currency beyond legitimate trade requirements. This difficulty would not arise if note-issue is controlled by a single bank. "The very independence of a bank with monopoly privileges removes from it all temptation such as might be presented in competition with rivals, to extend its issue beyond the limit of safety. As the struggle to earn dividends is absent the bank may order its policy to secure public welfare."<sup>1</sup> It is possible to assign responsibility and to check faults. "It puts an unmistakable duty upon those in whose hands the course of monetary affairs rests and makes impossible the negligence and irresponsible venturesomeness observable with a multitude of competing banks."<sup>2</sup> Hence, note-issue must invariably be controlled by one bank, preferably the Central Bank of the country.

**Case of India.** It will be interesting in this connection to remember that the Indian paper currency system has passed through all these phases. Notes were first issued by the three Presidency Banks but came to be issued by the Government in 1861. The defects of the system soon became apparent and an half-hearted attempt was made to transfer control to one bank when the Imperial Bank was empowered to issue notes upto Rs. 12 crores in the busy season on the security of inland bills of exchange in 1924. A real step in the right direction has been taken now that the newly constituted Reserve Bank has been made wholly responsible

1 Jones—*Economic Crises*, P. 111.

2 Jones—*Ibid*, p. 111.

for the management and control of paper currency in India.<sup>1</sup>

**Systems of Note-issue.** While the economists admit the necessity of elasticity as a necessary feature of a good system of note-issue, they are not agreed as to the *degree* of elasticity that any system should possess and the *extent* to which the limit of safety may be transgressed. An attempt has, therefore, been made to give a general idea of the systems prevailing in different countries which will also incidentally illustrate the difference of opinion concerning the principle of note-issue.

### Existing Methods of Note-issue.

1. *Fixed Maximum of Note-issue*—as prevailed in France upto 1928<sup>2</sup>. According to this system there is no fixed relationship between the note circulation and the amount of metallic reserves. The law prescribes a maximum limit of note-issue which cannot be exceeded no matter what the amount of reserves may be. The maximum is generally in excess of what the note circulation is expected to be in normal circumstances and is liable to be revised upwards from time to time. This system is *inelastic* because in fixing the maximum it pays no regard to the relation that must exist between the note issue and trade requirements. It has the advantage of allowing unlimited discretion to the Central Bank of using the reserves in times of need while preventing any tendency towards inflation. "If the volume of the note-issue is to be regulated by law this is perhaps the best system."<sup>3</sup>

1 Also read chapter XIII.

2 The legal maximum fixed was 59,431 million francs.

3 Keynes—*A Treatise on Money*, vol. II, p. 266.

2. *Fixed Fiduciary Issue* (or the *Currency Principle*). This system was inaugurated by the English Bank Charter Act of 1844 and still prevails in Great Britain, Norway and Japan.

In the case of England, the Bank of England is authorised to issue notes<sup>1</sup> through the Issue Department which is quite distinct from the Banking Department. Before 1928 the Bank was allowed to issue notes upto a total of £ 19,750,000 without putting any gold or silver in the reserve. This was the Bank's maximum fiduciary issue and all notes issued in excess of this sum had to be fully backed by gold. By the Currency and Bank Notes Act of 1928 the Bank has been authorised to issue notes against the Issue Department's total holding of gold coin and bullion and, in addition, to issue notes against securities to an amount of £ 260,000,000. The fiduciary limit cannot be increased except by the sanction of the Treasury and may not continue for a period of more than two years without the ratification of the Parliament. The original fixed fiduciary principle continues with the only difference that the limit of the fiduciary portion has been gradually raised from £ 14 millions in 1844 to £ 260 as at present.<sup>2</sup> That the system has become fairly elastic since 1928 can be proved by the fact that in September 1931, when the Bank's gold stocks were completely exhausted on account of heavy withdrawals by the Continental countries, the fiduciary issue was increased from £ 260 million to £ 275 million.

1 In addition to the notes of Bank of England, notes are issued by certain Scottish and Northern Irish Banks but the latter are not legal tender in England and Wales.

2 There have been violent changes recently. The limit was raised to £ 275 million on August 1st, 1931 and lowered to £ 260 million on March 31st, 1931. On December 15th, 1936, the limit was lowered to £ 200 million and in November 1937 it was raised to £ 220 million for a period of two months.

In Japan, the Bank of Japan is allowed to issue notes to an amount not exceeding Yen<sup>1</sup> 120,000,000<sup>2</sup> on the security of Government debt, other reliable securities or commercial bills. Any issue over and above this limit is to be secured by 100 per cent gold and silver. In its essentials, therefore, it resembles the English system.

This system requires that almost *all* the notes should be backed by an *equivalent amount* of gold (and/or silver) in the reserves. It restricts the fiduciary portion to a nominal figure with an additional *proviso* that the net circulation of note will be reduced as soon as a portion of the metallic reserve is lost by the exportation of gold to foreign countries. On the eve of the Great War the Government of India was legally authorised to issue notes worth 20 crores of rupees only against securities and had to find bullion or coin for the rest. This system obviously makes the note-issue as *safe* as *gold bullion certificates* which are free from the artificial manipulation of currency. It would work particularly well if the fiduciary issue is fixed high enough to leave the Central Bank in un-fettered control of the bulk of its gold reserves. It is, however, regarded as *un-economical* because it makes the expansion of paper currency dependent not upon the prosperity of trade but upon the increase in the output of gold and silver mines. It renders the issue of currency very *rigid* and *inelastic* and necessitates locking up of enormous quantities of gold which could otherwise be used for productive purposes. It is unsuited to countries where gold coins do not circulate.

### 3. *The Percentage System, (or the Banking*

1 Yen=Rs. 1-6-0.

2 This limit was raised to 1,000 million yens on July 1st 1932.

*Principle*) which has been characterised by Mr. Keynes as "the most fashionable system at the present time" exists, among other countries, in the United States, France, Germany and India. It does not require the note-issuing and banking functions to be separated into two different departments. It prescribes that the gold reserves shall not fall below a fixed percentage (30 to 40 per cent) of the note-issue. The minimum is not rigidly fixed but may be lowered with the consent of the government for short periods on the condition that the issuing bank pays a tax calculated on the amount of the deficiency. In the case of America the legal minimum of gold and gold securities is 40 per cent and the rest of the 60 per cent consists of commercial paper (bills of exchange etc.,) which the Federal Reserve Bank is allowed to deal in. In Germany<sup>1</sup> also the Reichsbank is compelled to keep gold, covering at least 40 per cent of the total circulation, subject to reduction on payment of a tax. The remaining cover has to consist of bills of exchange or other authorised securities. In the case of Australia, Argentine, Canada, New Zealand, Czechoslovakia, and Yugoslavia, on the other hand, the reserve requirement is only 25 per cent. Before April 1935, the Government of India could issue notes against 50 per cent gold (and silver) and 50 per cent securities so that whenever more notes had to be issued it had to find much less gold than before the War (when India had the Fixed Fiduciary System). The present system is even more liberal<sup>2</sup>.

<sup>1</sup> This country, however, suspended the legal reserve requirement of its central bank in September, 1932.

<sup>2</sup> The Issue Department of the Reserve Bank of India must hold 40% of its assets in gold coin, gold bullion (gold must not be less than 400 million rupees and at least 85% must be held at home) and sterling securities, and the remainder of its

[ Continued on page 28 ]



This method permits the issuing authority to issue notes in any amount to meet the demand of trade provided that there is *sufficient* gold in the reserves to convert notes on demand. The note-issue under this system is more *elastic* but this elasticity is secured at the expense of deliberate or unconscious *inflation* of currency with a corresponding rise of prices. It is *extravagant* in locking up gold for it does not exempt the irreducible minimum of note-issue permitted by the Fixed Fiduciary System. It also creates serious *tightness* of currency in the event of gold leaving the country in large amounts.

4. This is a variant of the 3rd. According to it, all or some part of the percentage reserve required against the note-issue may be held, not in actual gold, but in bills or cash at some foreign bank. The method is usually adopted by countries which have restored the gold standard with the assistance of the League of Nations and is in accordance with the recommendations of the Genoa Conference of 1922. It has the great advantage of economising gold but is open to the same objections as the "percentage" method. The economy of gold is, more-over, optional and there is a danger that considerations of fashion and prestige may lead some countries to hold actual gold.

**The Right Principle of Note-issue.** The system which a country should adopt would depend mostly upon the supply of gold, the habits of the people, and the conditions of the money market etc.,

[ *Continued from page 27* ]

assets may consist of rupee coin, securities, eligible bills of exchange and promissory notes. For legal reserve requirements of other countries of the world read League of Nations' *Monetary Review* for 1937-38, pp. 87-89.

but, as a matter of principle, every civilised country should have only one form of note and that issued by the Central Bank. The Bank should be quite free to manage its own reserves and those of the member banks but the law may usefully limit its discretion in two ways, namely, (a) it may require that the gold reserves shall not fall below a stated minimum figure, and that (b) the note-issue shall not exceed a fixed maximum. This would create a psychological confidence and prove a delaying safeguard in emergencies. Such a system exists in Italy and Spain. In the case of Spain, the reserve requirement is peculiar. The percentage is made to increase with increase in issue up to the maximum limit. It is unduly safe and hence inelastic and does not serve as a good model to more enterprising countries.

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#### SUMMARY

**Elasticity of Paper Currency.** Paper money must be elastic, that is, its supply must be capable of being increased or decreased in accordance with the requirements of trade. Elasticity is particularly necessary in the case of agricultural countries like India where the demand for currency varies from season to season and where cheque currency is comparatively less popular.

**Mobility of Paper Currency.** Refers to the ability of paper currency to be moved from places where it is abundant to places where it is scarce.

**Government *versus* Bank Note-issue.** The government departments do not keep in direct touch with trade and industry nor are they sensitive to conditions in the financial and commercial world. They study every problem patiently and minutely and are, therefore, unable to make quick decisions in emergencies. There is also the danger of political considerations and financial needs of the state determining the volume of currency in circulation. The bank note-issue is consequently more desirable.

**Single *versus* Multiple Note-issue.** Should one or all banks be allowed to issue notes? One bank can co-ordinate credit and currency more effectively and can ensure greater degree of elasticity and mobility than many banks following conflicting policies. A single bank has less temptation to make profits out of note issue and can at once be pulled up as soon as that desire becomes apparent.

**Systems of Note-issue** In order to secure elasticity and yet provide sufficient safeguards against undue expansion (and contraction) of currency, the note issue should be entrusted to the Central Bank which generally bases its issue on any of the four well-recognised principles, *viz.*: (1) Fixed Maximum of Note-issue, which puts a maximum limit (which may be gradually increased) to note-issue which cannot be exceeded in spite of the size of the reserves. It does not regulate note-issue in accordance with the needs of trade but puts unlimited powers in the hands of the Central Bank to expand currency without the fear of inflation. (2) Fixed Fiduciary Issue, (prevalent in England, Japan and Norway). It provides that, barring a small amount of notes which may be backed by securities, the rest must be fully covered by metal in the reserves. It is safe but uneconomical and makes note-issue comparatively inelastic and unresponsive to the requirements of trade. (3) Percentage or Proportional Reserve System, (exists in U. S. A., Germany, India, etc.) It allows a certain fixed percentage (30 to 40 per cent) to be covered by metal and the rest by securities. This secures greater elasticity but only at the expense of deliberate or unconscious inflation of currency. It may also lock up too much gold in the reserves, and, on the other extreme, bring about a drastic reduction of note-issue in the event of gold being exported out of the country. (4) This system is a variant of the third. It permits reserves to be maintained not in gold but in bills and cash in foreign banks. It economises the use of precious metals but is exposed to the same defects as (3). In actual practice, however, large number of countries, out of considerations of fashion and prestige, prefer to hold actual gold.

**The Right Principle of Note-issue.** The system of each country would depend upon its own economic conditions but if the law fixes a minimum absolute figure for the gold reserve and a maximum absolute figure for the note circulation, both these limits being subject to reasonable revision from

time to time and so chosen as to allow a wide discretion to the Central Bank, no more safeguards are necessary.

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### QUESTIONS

1. What do you mean by "elasticity" and "mobility" of paper money?

2. Give arguments for and against the government system of note-issue. Assuming the government monopoly of note-issue being undesirable, what other alternative or alternatives would you suggest and why?

3. Point out clearly the comparative merits of the Fixed Fiduciary Issue system and the Proportional Reserve system of note-issue in a country like India.

[Delhi Inter. 1930 and Delhi B.A. 1933].

4. What do you think is the right principle of note-issue? Illustrate your answer with reference to the systems prevailing in different countries of the world.

## CHAPTER IV

### CREDIT MONEY

**Meaning of Credit.** We have seen that the sale and purchase of commodities can be made by money. It now remains for us to see how the same object can be accomplished *without* the use of money. A man wants a hundred rupees, and, if he has nothing tangible to offer in exchange, he borrows them against a promissory note. A shop-keeper wishes to purchase goods from a producer for sale but he cannot pay for them straight-away. He, therefore, gives a written promise to pay the price of the goods sometimes hence. In either case capital has been put by one man at the command of another to be re-paid at some future time. Credit, therefore, may be defined as '*protracted exchange*,' that is, exchange which is not complete until a certain period of time has expired. "Introduce the element of time into exchange," says Gide, "and it becomes credit....credit may be defined as the exchange of present wealth for future wealth."<sup>1</sup>

Now, no man will part with his goods in exchange for a promise to pay money unless he has confidence in the ability and will<sup>2</sup> of the debtor to make payment when it falls due. This confidence is partly based upon the borrower's property and partly upon his personal characteristics. Every creditor will satisfy himself about the character of

<sup>1</sup> *Principles of Political Economy*—p. 356.

<sup>2</sup> Or, in his Character, Capacity, Capital and Collateral which are popularly known as the four "C's" of credit.

his client and the character of his business<sup>1</sup> before granting credit. Hence, the fundamental elements of credit are time and confidence.<sup>2</sup> Tucker has defined credit as "the transfer of something valuable to another, whether money, goods or services, in the confidence that he will be both willing and able, at a future day, to pay its equivalent."<sup>3</sup> The extension of credit between nations depends upon the stability of political institutions, the general economic organisation of each country and upon the state of law relating to borrowing and lending especially the readiness with which contracts can be enforced. Similar considerations apply in the case of different industries in the same country. Those which possess the greatest power to borrow are those which can show the greatest progress as measured by profits while those that have lost their credit in the market owing to defective organisation or persistent losses find it very difficult to tempt investors to entrust their money to them.

**Instruments of Credit.** Although trust or confidence is the essence of credit it is customary for there to be in existence some tangible evidence of the debt created. Since credit involves a promise of repayment at some future time, written evidence of the existence of the debt is usually taken by the

1 There is a close relationship between these two factors because "a man of excellent business ability.....would have his business properly organised and, on the other hand, if it were found that a business was poorly equipped and managed, it would be certain that the man's business experience or business capacity was strictly limited. An investigation of these two kinds, however, usually serves to furnish a more adequate basis for a sound judgment of the risks involved." Marshall—*Industrial Society*, p. 328.

2 The word 'credit' has been derived from a Latin word 'Credo', which means 'I believe'.

3 *Theory of Money and Banks Investigated*, p. 121.

H. D. MacLeod in his *Theory of Credit* has defined credit as "a right of action." This gives us the legal aspect of credit. A man who gives a promise to pay money gives a right of action against himself. The holder of the promise may sue him for payment and the law will enforce the payment.

creditor from the debtor and such forms of evidence are known as *Credit Instruments*. These include Bills of Exchange, Drafts, Promissory Notes, Book Credits and Cheques, etc. The Bills of Exchange and the Bankers Drafts are used for foreign remittances or among people living in distant corners of the same country and have, therefore, been discussed in the chapter on Foreign Exchanges. Here, we will discuss the meaning and working of the other credit instruments, *viz.*, Promissory Notes, Bank Notes, Cheques and Book Credits.

**Promissory Notes.** A promissory note is an unconditional promise in writing to pay a certain sum of money at a stated time. It is the simplest form of credit instrument and is probably the first one that came in use. It may be given by a man or woman, by a firm or corporation, in order to borrow money or in payment for goods. It will not be accepted except by men who have confidence in the maker or the witness (endorser) whose signatures are also required to complete the transaction. A promissory note, therefore, is capable of serving as a medium of exchange only within a narrow field. Its main use is not as a medium of exchange but as an instrument for the transfer of capital from lenders to borrowers.

**Bank Note.** It is a bank's promise to pay money to bearer on demand. The acceptability of bank notes is due to the prevailing confidence in the stability of the banks and to the convenient denominations in which the notes are issued. "Credit is a bank's stock in trade, something which it must maintain at all costs. Its failure to redeem one of its promises on demand means immediate bankruptcy and ruin. Banks, therefore, guard their credit as a woman does her good name and as a

result people come to feel that a bank's promise to pay money is as good as money itself."

The only difference between a promissory note and a bank note is this that the former bears interest and is private. Its full value cannot be demanded until it matures. A bank note, on the other hand, is convertible at par into legal tender money on demand. It does not bear any interest.

**Cheques.** A cheque is a written order given to a banker by a depositor requiring him to pay on demand a definite sum of money, either to a specified person or to his order, or to the bearer.<sup>1</sup> It is a command which the banker has undertaken to honour to the extent of the amount that the drawer had previously deposited with him. The bank will obey this order if the drawer of the cheque has a sufficient sum standing to his credit at the bank to cover the amount named in the cheque, or if the bank has given him the right to "over-draw" to that extent. Otherwise the cheque will be returned to the person who presented it marked R/D (Refer to Drawer) or N.S.F. (Not Sufficient Funds). The cheque, in effect, assigns to a creditor part of the funds at the debtor's disposal. Its usual effect is merely to alter figures in the banker's ledgers or books. The payee's account is increased while the drawer's account is decreased by the amount of the cheque. Like a bank note, a cheque bears no interest and is transferable from hand to hand without any formality so that the holder is *prima facie* the owner. "If there is no doubt at all as to the credit both of the drawer and of the bank on which the cheque is drawn, it is difficult to see why a cheque should be inferior to a bank note as representative

<sup>1</sup> The Bill of Exchange Act of 1882 defines a cheque as "A Bill of Exchange drawn on a banker, payable on demand."



money, except that it is usually drawn for an odd sum."<sup>1</sup>

**Crossed Cheques.** In order to avoid payments being made to wrong persons cheques are generally 'crossed' by drawing two parallel lines on their face with the words '& Co' written in between them. The crossing assures that the cheques will in any event be paid only through a banker. The amount is simply credited to the account of the man in whose favour it has been drawn so that if there is a mistake it can be easily detected later on.

Cheques are generally less popular because it is impossible to be acquainted with the cheque forms of all banks, the signatures of those who draw them and the credit of the drawers. Every one accepting a cheque does so at the risk of fraud or bankruptcy on the part of the drawer. There is also the possibility of failure of the bank on which it is drawn in which case the drawee, or the man in whose favour the cheque is drawn, loses—the liability of the drawer having ceased as soon as payment by cheque has been made.

**Book Credit.** It is a very popular form of "business credit" now-a-days. After the buyer has completed his purchase an entry is made in the books of the seller indicating the nature of the articles bought and the date and prices at which they are purchased. Charges for professional services such as those of a doctor or a lawyer also fall in the same category. Book accounts are finally settled either by some other form of credit, as by cheque or draft, or by the payment of cash. This method is not only a quick and easy way of recording a sale on credit but it minimises the time

1 Jevons, *Op. Cit.* pp. 240-241.

of both purchasers and sellers and obviates the necessity of carrying large sums of money to make cash payments. In practice, however, it is attended by numerous abuses. A book entry is subject to dispute. There may or may not be a definite date agreed upon as to when payment is to be made although the seller may sometimes offer a discount to facilitate settlement within a short period of time. It locks up the invested or borrowed capital of the seller for an indefinite period of time and is frequently a prolific source of slow collections, bad debts and huge losses. The sellers are, therefore, compelled to quote higher prices which are passed on at continually increasing levels to the consumers.

**Characteristics of Credit Money.** Like all other forms of money, credit instruments also must possess at least four qualities, *viz.*: (1) They must be issued by a person in whom all people have confidence; (2) they must be in convenient denominations; (3) they must be easily recognisable; and (4) they must be difficult to counterfeit.<sup>1</sup>

They differ from money instruments in more than one respect. They have no intrinsic value and circulate on the strength of the reputation and financial stability of a single person or institution. They pass less frequently and less rapidly from hand to hand and are seldom hoarded. Unlike money, all forms of credit do not possess the same degree of acceptability. A man's cheque or promissory note, for instance, will be taken only by people who know him and trust him whereas every one will accept a bank note. Credit may, therefore, be divided into two classes: (1) credit of general-acceptability, such as bank notes; (2) credit of limited acceptability, such as bank cheques,

<sup>1</sup> Johnson—*Money and Currency*—p. 42.

drafts, and promissory notes. Credit of the first class is often called *money* and is even so named in some scientific treatises but we have treated it as credit.

**Does the Creation of Credit Mean the Creation of Wealth?** In view of the important part played by credit in the industrial life of to-day, some people are inclined to believe that credit instruments are real wealth, true capital. They believe that credit is a factor of production and that it can create wealth quite as well as land or labour. But this is an illusion. Credit is *not* a factor of production. It is merely a *method* of production just like exchange and the division of labour. It consists in the *transfer* of wealth or capital from one person to another. *But to transfer is not to create.* Credit can no more create wealth than exchange can create commodities. As Mill has neatly put it, "credit is simply permission to use the capital of others." Suppose, for example, A lends Rs. 100 to B and gets a promissory note from him in return. The total is undoubtedly Rs. 200 (Rs. 100 in cash with the borrower and a note worth Rs. 100 with the lender). B's note, however, may be capital for A but cannot be capital *for the nation* for A cannot negotiate the paper until some one will give him money or goods in exchange for it. The promissory note, therefore, is not capital but simply affords A an opportunity of obtaining other capital in lieu of what he has given up. Besides, A cannot support life or carry on production merely by means of pieces of paper. If credit instruments really constituted wealth, it would be quite possible to double the wealth of any community by having each citizen to lend his estate to his neighbours in exchange for a promissory note. It cannot, however, be denied that if the borrower makes a productive use of the money which the lender had

allowed to remain idle, there would be some justification for calling credit capital. For money borrowed for the improvement of business and production is nothing but credit for purposes of production. Thus, credit does not increase capital in any material sense, nor is it, in its inception, an increase of capital. It is but a means by which capital can be given mobility—and hence greater efficiency—just as horses which give to cavalry-men no increase in actual numbers, but impart to them greater mobility and increased activity.

**Advantages of Credit.** Although credit cannot be called productive in the strictest sense of creating capital, it renders eminent services to production by enabling us to use existing capital to the best possible advantage. Even in the case of consumption, where it has ordinarily disastrous consequences, credit renders useful service in helping us to tide over temporary difficulty and to keep simple accounts. The advantages of credit, in a simple language, may be summarised thus :—

1. Credit helps production by transferring wealth from the possession of those who do not want it to those who can make a proper use of it.
2. It furnishes us with better and more convenient methods of payment of large sums of money inside the country (*e.g.*, a cheque) as well as outside (*e.g.*, a bill of exchange);
3. It acts as a stimulant to the growth of capital. The introduction of credit institutions (*e.g.* banks) and credit facilities (*e.g.* lending of credit) have encouraged saving and investment of capital; and
4. It enables us to economise the use of gold

and silver as means of payment. The use of credit displaces gold in circulation and, to that extent, lowers the value of gold. This tendency can be noticed in western countries during the period 1896 to 1913.<sup>1</sup>

In short, credit makes possible a more complete utilisation of human and natural resources, stimulates large scale production, and increases the efficiency of labour and capital. It has become so much a matter of habit that we seldom give thought to it. Yet it has proved to be the most vital problem in the economic activities of the world since 1914. "As a tool of exchange money is a great time-saver. Credit, however, performs the same service and does it with infinitely greater rapidity. Money surpasses barter as the modern railroad 'flyer' surpasses the crawling canal boat, but credit leaps to its task with the swiftness of electricity. If the world were stripped of its telegraph wires, its means of communication would not suffer more than would the business world if credit were destroyed."<sup>2</sup> One is, therefore, not surprised to see that in the industrial countries of modern times the use of the ordinary media of exchange is becoming less important except for small transactions. "The soundness of the monetary systems of different countries and therefore of the world, must depend upon the soundness of the credit system—a system in which the ordinary legal tender plays the part of diminishing importance."<sup>3</sup>

**Evils of Credit.**<sup>4</sup> In spite of the numerous advantages conferred by credit on society its dangers should not be over-looked.<sup>4</sup> When money is

1 See Taylor *The Credit System*—Chapter II.

2 Johnson—*Money and Currency*—p. 53.

3 Vakil and Muranjan—*Currency and Prices in India*—p. 525.

4 Also read Evit—*A Manual of Foreign Exchange*—pp. 16-18.

borrowed for purposes of consumption, it is spent much more blindly than the one earned with the sweat of the brow. Similarly, when funds are raised for productive enterprises, the borrowers are tempted to spend them much more recklessly than if the money was their own. This frequently leads to over-production, over-investment and speculation which is often a cause of business destruction. The credit system disguises the financial weakness of a business community by enabling the unscrupulous people to continue in business with the help of borrowed money. The eventual failure of such people brings ruin not only to themselves but to many of those who had established commercial relations with them. If the amount of credit money is much in excess of other media of exchange, there are chances of weakening public confidence. Utmost care is generally bestowed to the control of bank notes and yet a single untoward event may often shake public confidence and result in drastic contraction of currency. The modern credit organisation is also responsible for concentrating capital in the hands of big capitalistic producers and indirectly responsible for the exploitation of labour and extermination of small-scale producers. Since credit is the life-blood of modern trade and industry, it is necessary to control it through some responsible agency which in most-countries is the central bank.

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### SUMMARY

**Meaning of Credit.** Credit may be defined as 'protracted exchange,' that is, exchange of present wealth for future wealth. The fundamental elements of credit are *confidence* and *time*. All credit transactions are based on the confidence in the ability of the borrower to return what he owes together with any agreed interest payments and also in his willingness to make such payments. They are helped by the stability of political institutions, the general economic conditions and the laws of each country.

**Instruments of Credit.** Bills of Exchange and Banker's Drafts are discussed in the chapter on Foreign Exchange. A Promissory Note is an unconditional promise in writing to pay a certain sum of money at a stated time. It is frequently used by borrowers of money and circulates within a very narrow field. A bank note is a promissory note issued by a bank. It is convertible into legal tender money on demand and does not bear any interest. A cheque is an order drawn on a bank by an individual holding a deposit with it and calling upon it to pay a specified sum of money to the bearer or the person named on the cheque. It resembles a bank note in all *essential* respects except that while the former may be drawn for an odd sum, the latter is always drawn in round figures. To avoid payment being made to wrong persons cheques are generally crossed with two parallel lines being drawn across them with the words "& Co" written in between. A crossed cheque cannot be cashed. It can only be credited to the account of the holder. Cheques are generally risky. Everybody accepting them does so at the risk of fraud and bankruptcy. Book Credit is an entry in the books of the sellers indicating the articles and date of sale. It is safe and convenient except when debtors hold up payments for long periods resulting in heavy losses to the creditors. To guard against such emergencies, sellers generally charge higher prices from those buyers who are not likely to be prompt in the settlement of their accounts.

**Characteristics of Credit Money.** It must be issued by people who can inspire confidence. Credit instruments must be convenient in size and shape and difficult to counterfeit. They possess no intrinsic value, have limited circulation and are rarely hoarded.

**Is Credit Capital ?** No. Credit is not capital nor a factor of production in the same sense as land and labour are. Credit is only a *method* of production just like division of labour. It does not create wealth but simply transfers it. If in this act of transfer it makes wealth *more productive* there may be some justification in regarding it as capital.

**Advantages of Credit.** It finances the producer who is engaged in turning out goods in anticipation of demand. It enables those who have saved to invest their savings and obtain an income. It is a convenient means of payment and permits economy in the use of precious metals.

**Evils of Credit.** When borrowed for unproductive purposes,

loans are often misused. Even in production, borrowers are more inclined to play with the money of others than with their own. It leads to capitalistic exploitation and extermination of small scale producers.

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### QUESTIONS

1. What is credit ? Describe its nature and the forms in which it is expressed  
[Punjab B. A. 1931]  
[Delhi Int. 1932]
  2. Distinguish between money and credit instruments. What are the advantages of credit to modern commerce and industry.  
[U. P. Board Int. 1933]
  3. Distinguish between a cheque and a bank-note. "The use of cheque involves the element of belief to a much greater extent than that of the bank-note." Explain how?  
[U. P. Board Int. 1933]
  4. "Can Credit Create Capital" ?  
[Delhi Int. 1930]  
[Calcutta B. A. 1923]
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## CHAPTER V

### VALUE OF MONEY—INDEX NUMBERS

**Meaning of the Value of Money.** While recounting the services of money to mankind we had observed that the use of money may lead to great peril and confusion if its value does not remain stable. We shall now study that point a little more in detail. The expression "value of money" is used in various senses. In the first place, it is used to denote the rate of interest or the rate of discount which is nothing but a reward for lending money for long or short periods respectively. It is also used to indicate the value of the monetary unit of one country in terms of the monetary unit of another which is more popularly called the rate of exchange and which is more fully discussed in the chapter on Foreign Exchanges. But for our purpose in this chapter we shall use it to refer to the ability of money to command other goods and services in exchange. In this sense the value of money is analogous to the value of anything else. Just as the value of bread, cloth etc., may increase in the sense that the amount of money demanded in exchange has increased, similarly, the value of money may be said to have increased if the amount of things in general, which will be given in exchange for a given unit of money, has increased. Thus, while the value of commodities is measured in terms of money, changes in the value of money must be measured by the upward and downward movement of prices in general. Such changes are spoken of as variations in the general level of prices or, as a rise or fall in the purchasing power of money. To use a mathematical phrase, prices are the ratio between the value of

money and of other commodities and may be altered by a change either on the side of money or on the side of commodities.<sup>1</sup>

**Importance of Fluctuations in the Value of Money.** Under the complex conditions prevailing in the modern world, all complicated stages of a business transaction are rarely completed at one time. In the majority of cases they involve contracts expressed in terms of money, their settlement being deferred over widely varying periods of time. It is, therefore, desirable to have a correct idea of the extent of the variations in the purchasing power of money to fix the value of deferred payments and to correct the hardships to debtors or creditors, to wage-earners or to those in receipt of fixed rents and incomes which often arise from such variations in price levels. Comparisons in the purchasing power of money, at different periods of time, throw considerable light on the economic condition of different classes and enable us to form a fairly correct idea of a rise or fall in the standard of comfort.<sup>2</sup> A few examples will make it clear. Suppose a man earns about Rs. 50 a month. He is able to buy just as many commodities as are urgently required for himself and his family. If the prices of commodities go up, or what comes to the same thing, if the value of his money decreases, he shall be able to buy fewer commodities only and thus starve his family of some of the most essential necessities of life. Similarly, if a man lends Rs. 100 at a time when prices are low and gets them back when prices are high, he actually receives *less purchasing power*, or fewer commodities, than what he had originally parted with. Hence, when the purchasing power of money changes,

1 Layton and Crowther—*An Introduction to the Study of Prices*, p. 8

2 Also read end of Chapter VI.

either the debtor or the creditor loses more than justice demands. "Men sow where they do not reap and reap where they do not sow".<sup>1</sup>

**Measurement of Price Changes—Index Numbers.** The usual method of measuring changes in price (and the purchasing power of money) is by means of Index Numbers. The Index Number shows, at a glance, variations in the prices of articles in general—called price level—as well as of individual commodities with corresponding changes in the value of money. It is a number which represents the price of a chosen commodity, or group of commodities at a selected date (called the *base*) which is used as a standard wherewith we may compare the prices of the same article at a later date. Suppose that wheat, cloth, sugar, rice and ghee are the articles selected and that we wish to ascertain how much the value of money has changed with respect to those since 1925. Now, suppose that wheat has risen from Rs. 5 to Rs. 7½ a maund, cloth from Re. 1 to Rs. 1-8-0 a yard, sugar from Rs. 20 to Rs. 25 a maund, rice has fallen from Rs. 20 to Rs. 15 a maund and ghee from Rs. 50 to Rs. 40 a maund. It is quite obvious that whereas the value of money in respect of the first three commodities has *declined* (owing to rise of their prices), it has *increased* in respect of the last two. It will also be noticed that the *degree* of the rise and fall is also not the same. In order, therefore, to ascertain whether the value of money, on the whole, has increased or decreased and the degree of this rise and fall, we would represent the price of each article in the basic year (1925) by 100 and call it the Old Index Number and represent the price of the same article in the subsequent year (1935) by a figure (here-in-after

1 Foster and Catchings—*Money*, p. 23.

referred to as the New Index Number) which bears the same ratio to the Old Index Number as the later price bears to the former. The sum of new index numbers divided by the number of articles will give the average for 1935 and the difference of this average from the basic index number (100) will show the change in prices during the period under discussion.

We may illustrate the construction of index numbers by the following table—called the Index Number Table :—

ARTICLES	1925		1935	
	Price.	Old Index Number.	Price.	New Index Number.
Wheat	Rs. 5 a md.	100	Rs. 7½ a md.	$\frac{100 \times 15}{2 \times 5} = 150$
Cloth	Re. 1 a yd.	100	Rs. 1½ a yard	$\frac{100 \times 3}{2} = 150$
Sugar	Rs. 20 a md.	100	Rs. 25 a md.	$\frac{100 \times 25}{20} = 125$
Rice	Rs. 20 a md.	100	Rs. 15 a md.	$\frac{100 \times 15}{20} = 75$
Ghee	Rs. 50 a md.	100	Rs. 40 a md.	$\frac{100 \times 40}{50} = 80$
Index Numbers		5   $\frac{500}{100}$	5   $\frac{580}{116}$	

It is clear from the above table that the prices, on the whole, (or the general price level) have increased from 100 in 1925 to 116 in 1935<sup>1</sup> i.e., by 16 per cent. We can also say that while in

<sup>1</sup> The figures are purely imaginary.

1925, 100 units of money could purchase the five articles given in our list, in 1935, 116 units would be required to purchase them. Hence the purchasing power of money has fallen by 16 per cent.

**Difficulties in the Way of Constructing Correct Index Numbers.** The index number tables are not easy to construct with sufficient degree of accuracy.<sup>1</sup> The selection of the *basic year* is of the foremost importance because if an abnormal year of uncommonly high or low prices is chosen it would tend to mislead the average reader regarding the rate of increase or decrease of prices of other years. It has become customary in many economic comparisons to take 1913 as the basic year but there is no particular object in so doing except in so far as it is the last year before the Great War when the prices were more or less stable all over the world. The official basic year in India is 1873. Some economists take the average price of a series of years as a more correct base *e.g.* the prices prevailing in 1845-50 constitute the basis of the *Economists* index numbers but the advantages derived from this course seem to be doubtful.<sup>2</sup> It is not always possible to obtain reliable figures of retail prices. Consequently, calculations are often based on changes in wholesale prices although it is well-known that they are not necessarily accompanied by changes in retail prices. Moreover, one can never be certain that the things whose prices he is comparing are always of the same *quality*. Another difficulty arises from the constant shifting of human wants. Articles of great consequence in one period may lose their importance in the next and may even cease to be

1 Cf. Marshall—"a perfectly exact measure of value is not only unattainable but even unthinkable." Robertson has also expressed the same view. Read his '*Money*', page 27.

2 See 1905 volume of Government of India's Index Numbers.

consumed at all. Again, *all* articles are not necessarily wanted by *everybody* and our estimate of the rise or fall of the value of a *particular* class may be completely wrong if it includes commodities not generally consumed by *that* community or if it does not include articles which constitute an important part of the consumption of *that* class of people. In other words, index numbers must be made with a definite purpose in view. If they are intended to measure changes in the value of money in the most general sense for a particular country they must include, in addition to all important articles of consumption, things like land and houses and the cost of service of education, railways and domestic servants etc.<sup>1</sup> But for the purpose of throwing light on changes in the cost of living of different sections of the society the selection of commodities must be different in different cases. It must also be emphasised that the index numbers are mere averages. The rise in the price of one commodity may be offset by a corresponding fall in that of the other but the people may be more seriously affected by the former than they are relieved by the latter.

**Weighted Index Numbers.** While calculating the average price for any year some statisticians do not attach the same importance to all commodities. For, if wheat prices rise 50 per cent. over the basic year and ivory prices fall to an equal extent, it will be obviously unfair to average the two and declare that prices as a whole have been unchanged. The part of ivory in our total trade is insignificant when compared to that of wheat. Consequently, a commodity which is more important in consumption or trade of a country receives

<sup>1</sup> Sauerbeck's list includes 37 articles, Soetbeer's 114, while the *Economist's Index Number* is based upon an average of 22 articles.

greater "weight" in accordance with its relative importance for the particular object in view. For example, if the value of wheat consumed in a country is four times the value of sugar and twice the value of cotton, the number 100 will be assigned to sugar, 200 to cotton and 400 to wheat. This sort of average is called the "weighted" average to distinguish it from the arithmetical average which is ordinarily used. Let us assume that the value of the five articles in the previous table is not the same and that they are consumed in the ratio of 5, 4, 3, 2, 1. The form of the previous Index Number Table will have to be changed as follows :—

Articles.	1925		1935	
	Prices.	Old Index Number.	Prices.	New Index Number.
Wheat	Rs. 5 a md.	$5 \times 100 = 500$	Rs. 7½ a md.	$5 \times \frac{100 \times 15}{5 \times 2} = 750$
Cloth	Re. 1 a yd.	$4 \times 100 = 400$	Rs. 1½ a yd.	$4 \times \frac{100 \times 3}{2} = 600$
Sugar	Rs. 20 a md.	$3 \times 100 = 300$	Rs. 25 a md.	$3 \times \frac{100 \times 25}{20} = 375$
Rice	Rs. 20 a md.	$2 \times 100 = 200$	Rs. 15 a md.	$2 \times \frac{100 \times 15}{20} = 150$
Ghee	Rs. 50 a md.	$1 \times 100 = 100$	Rs. 40 a md.	$1 \times \frac{100 \times 40}{50} = 80$
Total Units = $5 + 4 + 3 + 2 + 1 = 15$ .				
Index Numbers =		$15 \mid \frac{1500}{100}$		
			$15 \mid \frac{1955}{130.3}$	

The rise of prices according to this calculation is 30.3 per cent. as against 16 per cent. found on the basis of un-weighted index numbers. The weighted index numbers, therefore, give a more correct view of the rise or fall of prices (and conversely, of the decrease or increase in the

purchasing power of money) but, in actual practice, reliable statistics of total expenditure are not available and the relative quantities of different commodities consumed change considerably between one period and another. Hence, even some of the mathematical economists have expressed themselves against the system of "weighting." Edgeworth, for example, does not consider weighting of much importance and Giffen has expressed the same opinion.<sup>1</sup> Some of our best known index numbers, viz., those of the *Economist*, Jevons, Soetbeer, and Sauerbeck are based on unweighted averages.

**Making of Index Numbers in India.** After private attempts at presenting reliable index numbers had failed, the Department of Commerce and Industry of the Government of India began to issue an official publication upon price-movements entitled "Index Numbers of Indian Prices" in 1905. It deals with wholesale prices and contains 39 articles with 1873 as the basic year. It is of the unweighted type. Messrs. Vakil and Muranjan have regarded this procedure as most unsuitable to the case of a country like India. "In India, the annual wealth derived from agriculture is several times as large as that derived from all other sources. Even this total agricultural wealth is made up predominantly by certain staple commodities, while others are comparatively insignificant. The equal importance assigned to each of these 39 commodities has imparted to these series a most undesirable bias.....Among the different classes of goods themselves, the total share in the trade and commerce of the country is most unequally divided. Rice, wheat and sugar claim more than half the share of the total trade in foodstuffs. Cotton and raw

1 See the *Report of British Association*, 1888, p. 184



These figures show that whereas the prices of cereals and pulses have decreased, the cost of fuel, lighting, clothing and house rent has increased. The prices, on the whole, have fallen from 100 to 98 (*i.e.* by 2 points) proving that the working classes were slightly better off in April 1935 than just before the War (July 1914).

Similar statistics are maintained in some other towns *e. g.* Ahmedabad, Sholapur, Nagpur etc. It is highly desirable that cost of living index should be prepared in other important towns also, especially where wage payments are made mostly on a cash basis, in order that public opinion may be well informed in cases of labour disputes involving wages.

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### SUMMARY

**Meaning of the "Value of Money."** It may mean the rate of interest which is the reward (price) for the use of money. It may also imply the number of units of the money of one country that will be given in exchange for the money of another country. In this chapter the "value of money" has been interpreted to mean the exchange value of money in respect of goods (and services) within the country.

**Measurement of Changes in the Value of Money.** Changes in the value of money are measured by means of Index Numbers. An index number is a device for ascertaining the average rise or fall of prices of a number of commodities. Prices are quoted in all kinds of denominations—wheat per maund; cloth per yard; and shoes per pair. Such quotations are incomparable with one another and the index number serves to reduce them to a common base. Prices in a particular year—called the base—are taken and represented by 100 (old index number). Then the prices of subsequent years are found and represented by figures which bear the same ratio to the old index numbers as the latter prices bear to the former. The sum of index numbers divided by the number of commodities gives the average for two years and incidentally shows average rise or fall of prices.

**Difficulties in the Way of Constructing Index Numbers.** (1)

Difficulty of selecting a proper basic year for an abnormal year may prove misleading for comparisons ; (2) Difficulty of getting correct figures of retail prices. Hence, in compiling index numbers, wholesale prices are usually employed although their changes are not adequately reflected in retail prices ; (3) Difficulty of selecting commodities whose prices are to be incorporated in the index number formula since it is clearly impossible to include the prices of all commodities. This difficulty is overcome by making different calculations for different people and for different purposes because then only those articles may be included which have a bearing on the problem at issue.

**Weighted Index Numbers.** All articles are not equally important. In order to bring out their relative importance, the ratios of the value of commodities consumed in a fixed period of time are found and multiplied by the index numbers. For example, if the value of wheat consumed in a country is four times the value of sugar and twice the value of cotton, the number 100 will be assigned to sugar, 200 to cotton and 400 to wheat. In actual practice, reliable statistics of total expenditure are not available and the relative quantities of the different commodities consumed change considerably between one period and another. Hence, many eminent economists have abandoned 'weighted' in favour of ordinary index numbers.

**Making of Index Numbers in India.** They are compiled and issued by the Government of India. 'The Index Number of Indian Prices' contains 39 articles with 1873 as the base. It is not weighted and has, therefore, been adversely criticised by Messrs. Vakil and Muranjan in their *Currency and Prices in India*. According to them, agriculture in India is by far the most important industry and some staple agricultural products are much more important than others. Moreover, different goods are sensitive in different degrees to changes in economic conditions.

**Cost of Living Index Numbers.** Index Numbers are especially employed for the purpose of estimating changes in the standard of living of the same class of people in different periods. A specimen of the Cost of Living Index of the working classes of Bombay is given. It is weighted.

## QUESTIONS

1. What is meant by the "Value of Money"?
2. What is an Index Number? Explain carefully the method of constructing a simple index number and point out the use of index numbers for economists and businessmen. [Agra B. A. 1932 and 1934].
3. What precautions are necessary in using index numbers as a test of changes in the purchasing power of money? [Calcutta B. A. 1927].
4. Explain the importance of "weighting" in constructing index numbers and examine its practical difficulties.
5. What do you mean by Cost of Living Index Numbers? Construct a Cost of Living Index to show the difference in the standard of living of the factory labourers of your province since the War.
6. Write a critical note on the making of index numbers in India.

## CHAPTER VI

### VALUE OF MONEY (*Continued*)

#### QUANTITY THEORY OF MONEY

Having seen how changes in the value of money are measured, we proceed to determine the causes of such fluctuations. It has already been pointed out in the previous chapter that money, broadly speaking, is akin to any other commodity and that, as such, its value is determined by the same force *viz.* demand for it and supply of it available.

★ **Demand for Money.** The demand for money, which is essentially dependent upon the habits and customs of each community, consists in the total volume of business transactions of all kinds which have to be performed within a given time with the aid of all kinds of money. More money, for instance, will be required, other things being equal, in a country where the number of articles produced (and to be exchanged) is greater than when the number of such articles is smaller.

★ **Supply of Money.** By the supply of money is meant the quantity of money units available for use as a medium of exchange. "The supply of money", says Mill, "is all the money in circulation at the time; the demand for money consists of all the goods offered for sale. As the whole of the goods in the market compose the demand for money, so the whole of the money constitutes the demand for goods."<sup>1</sup>

<sup>1</sup> *Principles of Political Economy*—Book III, Chapter VIII, Section 2.

**The Quantity Theory of Money.**<sup>1</sup> The theory states—"The value of money, *other things being the same*, varies inversely as its quantity; every increase of quantity lowers the value and every diminution raising it in a ratio exactly equivalent." (Mill).

This is a self-evident proposition. In a primitive society, unaccustomed to credit, in which all the metallic money passes from hand to hand and each unit of money circulates once only, the quantity of metallic money determines the purchasing power of the monetary unit.

**Illustration from a Simple State of Society.** An example will make it clear. Suppose there are 100 commodities in a country and there are 100 rupees to purchase them with. Assuming that (a) each of the 100 commodities is bought and sold once, that (b) each of the 100 rupees is spent just once, and that (c) there is no barter or hoarding, the price of each commodity, on the average, would be Re. 1. Now, suppose that there are 200 rupees with which to purchase the same 100 commodities. Making the same assumptions as before, the average price of each unit of commodity rises from Re. 1 to Rs. 2. The number of commodities which Re. 1 purchased before can now be purchased with Rs. 2, in other words, the purchasing power of each unit of money has been cut by half. But, if instead of Rs. 100 there are only Rs. 50 in circulation and if all the conditions mentioned above are fulfilled, the value of money is doubled. It is, therefore, obvious that an increase in the amount of money causes a fall in its value and a rise in prices; and that conversely, a decrease in the quantity of money causes a rise in its value and a fall in prices, in each case, in proportion to the change in quantity.<sup>2</sup>

1 Advanced students must read Keynes's *A Treatise on Money* and *Tract on Monetary Reform*s

2 Note that the prices of commodities and the purchasing power of money are inversely proportional to each other.

**The Equation of Exchange.** The theory may best be explained with the help of an equation of exchange. Adopting the form adopted by Irving Fisher, the best exponent of the theory, let us represent the total annual expenditure on commodities in any community by  $E$  whilst the average amount of money in circulation is  $M$ . Now, it is hardly likely that the average amount of money in circulation ( $M$ ) is equal to  $E$ —the total expenditure. The same monetary unit must have been used a number of times to do the requisite amount of work. The capacity of money to change hands repeatedly is called its *velocity of circulation* (or the average rate of turn-over of money) and may be calculated by dividing  $E$  by  $M$ . Hence,

$$V = \frac{E}{M} \quad \text{or } E = MV.$$

In other words, the total circulation of money in the sense of money expended is equal to the total money in circulation multiplied by its velocity of circulation or turn-over.

In the above equation we have two sides—the “money side” represented by  $MV$  (i.e. the amount of money in circulation multiplied by its velocity) and the expenditure or “goods side” which is represented by  $E$ . The latter requires further elucidation. Let us suppose that the average price of a particular commodity, say wheat, within the period, is represented by  $p$  while the total quantity purchased in the same period is represented by  $q$ . Then the total expenditure on that commodity will be equal to the product of these two factors, namely,  $pq$ . Now assuming that wheat is the only article on which the money is spent, the equation will read as:

$$pq = MV.$$

But, in actual practice, many more articles enter into exchange at varying prices and in varying quantities. Let us designate the average price of each by  $p_1, p_2, p_3$ , etc., and the total quantity purchased by  $q_1, q_2, q_3$ , etc. Taking into consideration all these articles and the amount expended on each, the total expenditure will be equal to  $p_1q_1 + p_2q_2 + p_3q_3 + \dots + p_nq_n$  or, employing  $\Sigma$  as a symbol of summation,  $= \Sigma pq$ . Since the "money side" and the "goods side" must be equal, the equation will be

$$\Sigma pq = MV$$

But, if all  $p$ 's be represented by  $P$  and all  $q$ 's by  $Q$  we will have

$$PQ = MV$$

Further, since the number of things bought and sold ( $Q$ ) may also be represented by  $T$ , the total quantity of things produced and exchanged,

$$PT = MV.$$

$$\text{or } P = \frac{MV}{T} \left\{ \begin{array}{l} P = \text{average of all different commodity prices.} \\ M = \text{amount of money in circulation.} \\ V = \text{velocity of circulation of } M. \\ T = \text{total volume of trade affected.} \end{array} \right.$$

Put in this form, the theory states that, assuming  $T$  and  $V$  to be constant, prices vary directly as  $M$ . In other words, the price level ( $P$ ) varies (1) directly as the quantity of money in circulation ( $M$ ); (2) directly as the velocity of its circulation ( $V$ ); and (3) inversely as the volume of trade done by it ( $T$ ).

1.  $\Sigma$  means "sum of all such as."

### Example Modified to Suit Modern Conditions.

In the complex world of to-day, however, conditions are slightly different. In addition to metallic coins, there is a considerable amount of bank money always in circulation and, owing to improvements in means of transport and extension of banking facilities, each unit of bank money changes hands more than once. Representing bank money by  $M_1$  and its velocity of circulation by  $V_1$  the above equation may be amended as follows:—

$$P = \frac{MV + M_1V_1}{T}$$

Now, in a given community there is a definite relation<sup>1</sup> between the money in circulation ( $M$ ) and the bank money withdrawable by means of cheques ( $M_1$ ) so that if there is a change in  $M$  there will be a proportionate change in  $M_1$  leading to an exactly proportional change in the general level of prices.

We are now in a position to understand the true significance of the words "other things being the same" used by Mill in his definition of the Quantity Theory. "Other things" include the rapidity of circulation of money, the proportion of business done by barter and on credit, the condition of trade and the amount of business done.

1 "In a given community the quantitative relation of deposit currency to money is determined by several considerations of convenience. In the first place, the more highly developed the business of a community, the more prevalent the use of cheques... Again, the more concentrated the population, the more prevalent the use of cheques. In cities it is more convenient both for the payer and the payee to make large payments by cheques; whereas, in the country, trips to a bank are too expensive in time and effort to be inconvenient and, therefore, more money is used in proportion to the amount of business done. Again, the wealthier the members of the community, the more largely will they use cheques." Fisher—*The Purchasing Power of the Money*—pp. 51-52



The Quantity Theory of Money holds good if these "other things" remain unaltered but if there is a change in them  $P$  will be affected not by  $M$  alone but by all other factors mentioned on the right hand side of the equation viz.,  $M_1$ ,  $V$ ,  $V_1$  and  $T$ . To put it more simply, we might say:—

(1) the prices vary directly as the quantity of money ( $M$  and  $M_1$ ) provided the volume of trade ( $T$ ) and the velocities of circulation ( $V$  and  $V_1$ ) remain unchanged;

(2) that prices vary directly as the velocities of circulation (if these velocities vary together) provided the quantity of money ( $M$  and  $M_1$ ) and the volume of trade ( $T$ ) remain unchanged; and that

(3) prices vary inversely as the volume of trade ( $T$ ) provided the quantity of money ( $M$ ) and, therefore, the bank deposits ( $M_1$ ) and their velocities ( $V$  and  $V_1$ ) remain unchanged.

Thus there are five influences ( $M, M_1, V, V_1$  and  $T$ ) which directly influence the level of prices. Any other influences on prices must act through these five. Outside influences acting through  $T$  are:—

- (a) the differentiation of human wants;
- (b) diversification of industry; and
- (c) rapid transportation.

Those that act through  $V$  and  $V_1$  are:—

- (a) improvident habits;
- (b) use of book credit;
- (c) rapid transportation.

Those that act through  $M$  are :—

- (a) import and minting of money ;
- (b) bimetallism which introduces two metals in circulation ;
- (c) issue of bank notes.

Those that act through  $M_1$  are :—

- (a) extension of the banking system ;
- (b) use of book credit.<sup>1</sup>

**The Quantity Theory of Money as Applied to India.** It has been pointed out that prices are affected by many factors besides the supply and demand of money. In addition to the causes mentioned above, therefore, prices may rise as a result of increasing cost consequent on an increase of freight or the cost of coal, protective duties, establishment of monopolies, trusts or cartels and fall of exchange etc., without being necessarily accompanied by discovery of gold or silver mines. Prof. Fisher has himself admitted that the relation between the quantity of money and the price level does not hold good of transition periods. The words "transition periods" imply periods in which prices rise and fall. In such periods the magnitudes of the equation of exchange try to seek the equilibrium. The relation between money and deposits is not rigid and prices are not wholly the result of other magnitudes of exchange. All these magnitudes react upon one another in such periods. The proportional effect of changes in the quantity of money on prices is then only the ultimate effect after transition periods are over. But the transition periods are normal features of trade and commerce. They are not exceptions. Hence the quantity theory of money holds

<sup>1</sup> Irving Fisher—*Purchasing Power of the Money*, pp. 149-150

good only under hypothetical and static conditions and not under dynamic conditions. Therefore, the Quantity Theory of Money, *in its bald form*, does not apply to India any more than to any other civilised country of the world.<sup>1</sup> A careful study of the currency history of the world will show that it is impossible to discover any complete proof of the theory in a few summary comparisons in which other possible relations of cause and effect are ignored. There is rise and fall in prices but it is seldom proportionate to increase or decrease of money supply. Mr. Keynes, in an article in the *Economic Journal* for March 1909, showed, by means of the following table, that the percentage of increase in currency in India was *very nearly* the same as that of the rise of prices during the years 1903-1907.

Year.	General Index Number of Prices.	Estimated total of the currency on the 1st. of April of each year.
1903	100	100
1904	102	110
1905	112	115
1906	131	127
1907	140	136

1 It will be interesting to remember the rise in prices in the middle of the 19th century which accompanied the discovery and working of new gold mines, the rise which began during the last years of the 19th century and continued during the early years of the 20th century before the out-break of the Great War. It is true that this last phenomenon was accompanied by a very considerable increase in gold production in Australia and South Africa but it also coincides with a whole set of new facts—a general rise in custom duties, the development of labour organisations tending to restrict competition, trusts, cartels etc. Hence, scientifically we do not appear to be justified in holding for certain and *a priori* that there was a relation of cause and effect between this phenomenon and one of its possible antecedents, after ignoring other factors which exercised an influence in the same sense and which might afford a sufficient explanation.

The following table, based on the Report of the Controller of Currency, tells almost the same tale:—

Year.	Amount of currency in circulation. <sup>1</sup>	Percentage increase or decrease of circulating media.	Prices in Calcutta.	Percentage increase or decrease of Calcutta prices.	Prices in Bombay.	Percentage increase or decrease of Bombay prices.
	(In crores of Rs.)					
1920	414	100	201	100	216	100
1921	382	92	178	89	198	92
1922	381	92	176	88	187	87
1923	375	90	172	86	181	84
1924	390	94	173	86	182	84
1925	391	94	159	79	163	76
1926	384	93	148	74	149	69
1927	361	87	148	74	147	68
1928	368	89	145	72	146	68
1929	368	89	141	70	145	67
1930	328	79	116	58	126	58
1931	295	71	96	48	109	50
1932	316	76	91	45	109	50
1933	294	71	87	43	98	45
1934	307	74	88	44	93	43

It will be noticed that here the fall of prices is very much steeper than the reduction in the amount of circulating media proving thereby that "there are a large number of other factors, besides the quantity of money, which play a part in determining price-movements over short as well as long periods. These other factors are constantly shifting and difficult to measure and exert a greater influence than the quantity factor on the trend of prices. It still remains true to assert that the quantity of money is *one* cause amongst others whose importance may sometimes be overlooked."

<sup>1</sup> Does not include gold and subsidiary coins and credit money.

**Inflation and Deflation. Depreciation and Appreciation.** The words "Inflation" and "Deflation" relate to the *amount* of circulating media while the terms "Depreciation" and "Appreciation" apply to the *value* of money. When the supply of money (including credit), *relatively to the demand*, increases to such an extent that the prices in general rise and the purchasing power of monetary unit decreases the currency is said to be 'inflated' and its purchasing power to be 'depreciated'. Similarly, when the supply of money is reduced, *disproportionately to demand*, the currency is said to be 'deflated'. Deflation is invariably accompanied by fall of prices. It should be clearly borne in mind that an *ordinary* expansion of currency (and credit) such as may be rendered necessary by an increase in trade or population would *not* result in inflation. Inflation would only be caused either (1) by an abnormal or deliberate expansion of currency and credit beyond the amount necessary to supply the needs of trade at the existing level of prices, or (2) by a diminution of production, provided that the volume of currency remains unchanged.

**Causes of Inflation.** Inflation is sometimes due to *natural* causes like a sudden increase in the output of mines or heavy importation of precious metals as was the case between 1896 and 1911 when prices rose owing to the discovery of gold mines in South Africa. But it is more often brought about *artificially* in times of grave national emergencies. For example, it is an important means of combating the continued menace of the economic depression (falling prices) in America now-a-days. The most appropriate occasion for resorting to inflation is a great war like the one we had in 1914-1918. War calls for expenditure vastly greater than can be met by the ordinary revenues

of the State. Additional funds may be raised by borrowing which may be difficult and costly especially when the credit of the government is low. Fresh taxes may be imposed but only at the cost of the displeasure of the people. The simplest and the cheapest method, therefore, of getting more money is to put into circulation inconvertible notes which the government is not bound to redeem and on which it has to pay no interest. The huge mass of these notes increases the volume of money which is mostly employed for unproductive (war) purposes. This means that a great war carries with it not only an increased supply of money but also a decreased production and, therefore, decreased supply of commodities. The amount of money (and credit) increases much faster than the number of commodities and inevitably results in inflation. "It has been estimated that during the last Great War, and for sometime after it, while there was a decrease by 10 per cent in the supply of commodities in European countries, the means of payment were generally increased by at least as many hundreds per cent. .... The result of the creation of new money has been that a new buying capacity has been put at the disposal of the government. The total buying capacity of the communities having been increased in this way, without a corresponding increase in the commodities to be bought, a general rise in prices has followed. Consequently, an inflation has taken place in every one of the countries involved in the War."

↓ **Evils of Inflation.** The evils of inflation are many. When currency depreciates the creditors lose and the debtors gain because the money borrowed when it was dear is paid back when it is cheap. The interest payments become of less value to the creditors. The rise in prices results

in agriculturists, manufacturers, wholesalers and retailers obtaining large profits during the rise simply by holding their stocks which rapidly increase in market price. The wage-earning classes also lose since wages seldom increase in sympathy with, and in proportion to, the rise of prices. The enhanced profits of the entrepreneurs and the increase in the cost of living result in social unrest and labour troubles. The increased cost of production makes it difficult for the producers to compete in the markets of the world. Consumers and salaried persons also suffer because, while their incomes remain the same, they are called upon to pay higher prices for articles of consumption.<sup>1</sup> The artificial prosperity which accompanies inflation undermines the economic life of the country and often leads to thoughtless extravagance particularly among the profiteers. The prosperity gained from inflation is more apparent than real. "People so habitually reckon their incomes and resources in terms of money that they think themselves better off when money incomes go up. They disregard, for a time at least, that their expenses go up also."<sup>2</sup>

**Methods of Deflation.** Because inflation injures a large section of the population and robs them of a substantial part of their real income a policy of deflation is adopted to counteract its effects. Superfluous currency is pumped out of circulation either by cancelling inconvertible notes or by increasing the volume of production in the country. The Central Bank raises the discount rate to contract currency and even floats loans or sells

<sup>1</sup> For a detailed analysis of income-receivers according to the effects produced by a rise of prices read "*An Introduction to the Study of Prices*" by Layton and Crowther, p. 15; and Keynes—*A Tract on Monetary Reforms*.

<sup>2</sup> Taussing—*Principles of Economics*—Vol. 1, pp. 297-8.

securities to withdraw money from actual circulation.<sup>1</sup>

**Consequences of Deflation.** Like inflation, deflation also does not help everybody. In a period of falling prices the economic effects are, broadly speaking, the reverse of those discussed in connection with rising prices. The burden of falling prices tends to press most heavily on the business or entrepreneur class for, while their gross incomes decrease, the burden of taxation and wages remains practically unaffected. Heavy losses weaken productive enterprises and cause business failures and serious unemployment over the whole field of industry. The earning class benefits from a fall of prices since their money wage purchases a larger share of goods and services than before unless, of course, steeply falling prices so reduce the income of their employers (including the government) as to necessitate heavy retrenchment or cut in salaries. Similarly, in agriculture the falling prices have disastrous consequences. In the first place, the prices of agricultural products tend to decline more quickly than those of manufactured articles. The farmer, therefore, has to give a greater proportion of his produce in exchange for the manufactured goods which he buys. Secondly, the agriculturist has to wait for a much longer period than the manufacturer from the time when he commences production to the time when he can sell his produce with the result that he sustains heavy losses because crops prepared and sown at one level of prices are sold months later at a lower level. Moreover, "All incomes fixed in terms of money such as interest on the National Debt, debentures and other fixed-interest securities, remain unaltered.

<sup>1</sup> The procedure is technically called Open Market Operations and has been explained in the chapter on Banking in India in connection with the functions of Central Banks.



Thus incomes derived from those sources are able to purchase an increased proportion of the national output at the lower price level now prevailing... the proportion of the national output which can be purchased by these classes of recipients being increased, the amount left for distribution between the remaining sections of the community is reduced.”<sup>1</sup> Indeed it has been said that among the many causes of human retrogression—wars, pestilence, famine, bad governments, etc.—a long period of falling prices is perhaps the worst because it saps the very sources of human enterprise, deadening the desire to venture and by checking the leaders and most go-ahead sections of the community, stops national progress and jeopardises the position of the whole country.

It will be clear from the above discussion that both *rising* and *falling* prices are bad and that their evil effects are experienced particularly in the *period of transition* when the relative economic status and welfare of different sections of the community are profoundly affected. “The rising prices and falling prices have each their characteristic disadvantages. The inflation which causes rising prices means injustice to individuals and classes particularly to investors; and is, therefore, unfavourable to saving. The deflation which causes falling prices means impoverishment to labour and to enterprise leading entrepreneurs to restrict production in their endeavour to avoid loss to themselves and is, therefore, disastrous to employment. The counterparts are, of course, also true namely that deflation means injustice to borrowers and that inflation leads to the over-stimulation of industrial activity. Thus

1 *Report of the Committee on Finance and Industry*—(1931) p. 86.

inflation is unjust and deflation is inexpedient."<sup>1</sup> Hence, in the interest of social justice and harmony steady prices are the best. They promote stability of production, trade, employment and general business conditions. They also ensure justice between debtors and creditors and between the wage-earners and the employers. "There is no nobler work for the enlightened humanity of to-day than that of controlling money and monetary policy, of regulating the supply of capital and the level of prices and the habits of consumption in the general interest of mankind."<sup>2</sup>

**Reflation.** It is another important term widely used in economic discussions now-a-days. It denotes a condition of affairs where deflation has been carried out too fast or too far. If a policy of deflation has resulted in too great a fall in prices and too great discouragement of trade and industry, obviously the volume of currency and credit available

1 Keynes—*A Tract on Monetary Reform*. Seligman has also expressed a similar opinion. "Both rising and falling prices create an unstable equilibrium which means disturbance in industry and unequal gains or losses to different classes. It is not high or low prices as such which do the harm, but rising or falling prices"—*Principles*.

2 Wadia and Joshi—*Money and the Money Market in India*—p. 3.

It may be noted, however, that there are many difficulties in the way of price stabilisation especially in view of the existence of a large number of price-levels viz: retail price level, wholesale price level etc., Statistics of retail prices are difficult to get and the quality of goods going under the same name keeps on changing from time to time. Moreover, it would not be possible to stabilise the prices of *all* commodities in which case the people will tend to invest money in articles whose prices are controlled in preference to commodities whose prices are exposed to constant fluctuations. A still more fundamental criticism is that a policy of stable prices would not guarantee the absence of inflation or deflation.

In view of these difficulties, Hayek, in his *Future of Monetary Policy and Prices and Production*, has advocated a policy of *Neutral Money*, i. e., a system of money which will interfere as little as possible with the operation of non-monetary factors. According to him the ratios of exchange should be the same as under barter economy and the presence of money should not make any difference. In other words, money should be *neutral* in its effects on prices.

has been rendered too small. A certain resort to the processes of inflation may then be necessary but as the result is not inflation as such the processes used are covered by the term "reflation" to convey the distinction.

### SUMMARY

The chapter aims at investigating the causes of changes in the value of money. Money resembles all other commodities because, like the latter, its value is also determined by demand and supply.

**Demand and Supply of Money.** By the demand of money is meant the total volume of business transactions which has to be done by money while the supply of money implies the total quantity of money unit available for use as a medium of exchange.

**The Quantity Theory of Money.** Expressed briefly, the theory may be enunciated as follows:—Other things remaining equal, every increase in the quantity of money in circulation causes an exactly proportional increase in the general level of prices. This can be proved by a simple example. Supposing that there are 100 rupees and 100 commodities and assuming that all the commodities that are produced are bought and sold and that every unit of money circulates once only, the average price per unit will be Re. 1. If, instead of Rs. 100 there are Rs. 200 with which to purchase the same 100 commodities, the average price of each unit of commodity will be raised from Re. 1 to Rs. 2 (doubled) and the purchasing power of each unit of money will be reduced by half. The relation between the amount of money and the prices can also be explained with the help of an equation of exchange. If  $E$  represents the total expenditure in a given period of time and  $M$  the amount of money in circulation, it is improbable that each unit of money would have circulated once only. It must have changed hands many times over to complete the number of transactions represented by  $E$ . The tendency of money to change hands repeatedly is called its velocity of circulation and can be calculated by dividing  $E$  by  $M$ . Thus

$$V = \frac{E}{M} \quad \text{or} \quad E = MV.$$

Now,  $E$  represents the "goods side" and  $MV$  the "money

side." E represents the total expenditure incurred on the commodities purchased and may be estimated by multiplying the price of each article purchased by its quantity, or  $E = p_1q_1 + p_2q_2 + p_3q_3 + \dots + p_nq_n$ . Substituting this in the above equation, we get

$$p_1q_1 + p_2q_2 + p_3q_3 + \dots + p_nq_n = MV$$

or, simply  $\Sigma pq = MV$  or  $PQ = MV$ .

But, since Q can also be represented by T, the total number of transactions,

$$PT = MV \quad \text{or} \quad P = \frac{MV}{T}$$

In this form the theory states that V and T being constant, P varies directly as M. In the modern world, however, bank money and its velocity of circulation are quite as important as M. Making allowance for them, the formula may be amended thus :—

$$P = \frac{MV \times M_1 V_1}{T}$$

According to Fisher,  $M_1$  bears a fixed relation to M with the result that if M changes  $M_1$  also changes in the same ratio affecting P in the same proportion.

The exponents of the theory assert that M,  $M_1$ , V,  $V_1$  and T are the only five factors affecting P and that other factors like changes in human wants, improvements in means of communication and transport, extension of banking facilities and changes in the monetary standard etc., only influence prices through the five factors mentioned on the right-hand side of the equation.

The quantity theory of money is proved by the past currency history of India although recently other influences have been more predominant in determining the level of prices than the quantity of money.

**Inflation—Its Causes and Effects.** When the supply of money *relatively to the demand* increases to such an extent that the prices, in general, rise and the purchasing power of the monetary unit decreases, the currency is said to be *inflated* and its purchasing power to be *depreciated*. It can be brought about either by increasing the volume of circulating media or by decreasing the volume of production. Inflation is *natural* if it is caused by the importation of precious metals

or *artificial* if it is caused by an excessive issue of inconvertible notes (as during the War). It is harmful to the creditors and to the people earning fixed incomes. The agriculturists and manufacturers gain but only at the expense of the consumers and even their gain is temporary.

**Deflation—Its Causes and Effects.** If, on the other hand, the volume of currency is reduced in such a way that the prices fall, it is called *deflation*. Deflation may also be caused by a sudden increase in the volume of production—the amount of money in circulation remaining the same. When deflation occurs currency *appreciates*. Deflation is injurious to the producers and businessmen and confers a corresponding benefit on the wage-earners. Hence in a period of falling or rising prices conflict between the different sections of the community is inevitable. It is not high or low prices as such which do the harm but *rising or falling* prices. In the interest of social justice and harmony, therefore, steady prices are the best.

**Reflation.** If deflation has been carried out too far or too fast it may be necessary to raise prices up a little. This process of raising prices not resulting in inflation is called 'reflation.'

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## QUESTIONS

1. State and explain the Quantity Theory of Money and show under what circumstances it is possible for the price level of commodities to remain the same even though there may be an increase or decrease in the amount of money in circulation ?

[Delhi Inter. 1930 and Agra B. A. 1933]

2. State in simple form the Quantity Theory of Money making clear the hypothesis under which it is true.

[Delhi B. A. 1934]

3. What, according to the Quantity Theory of Money, would be the effect on general prices of the following (other things supposed to remain the same) :—

- (a) improvements in the means of communication ;
- (b) the growth of trade and population ; and
- (c) the development of deposit banking.

[Punjab B. A. 1923]

4. State what do you understand by the term 'inflation.' To what causes can it be ascribed and what consequences follow from it? Illustrate your answer with examples from the recent currency history of this or any other country.

[Agra B. A. 1931 and Delhi Inter. 1933]

5. If inflation has occurred, is it desirable that a policy of deflation should be adopted? Give your reasons. What are likely to be the main effects of a policy of deflation?

[Punjab B. A. 1926 and 1927]

6. How do changes in the value of money affect different classes of people in a country?

[Agra B. A. 1932 and Calcutta B. A. 1928]

7. Are rising or falling prices the best? Give reasons.

## CHAPTER VII

### FOREIGN EXCHANGES

We have seen that if the inhabitants of a country owe money to each other they can easily square up their accounts in the currency of their own country. The real difficulty begins when they start trading with foreigners who insist on payment being made to them either in their own currency or in the international currency, namely, gold. It is a matter of common knowledge that the currency medium of the present day no longer consists only of gold coins but of bank deposits and notes based on gold and these bank deposits and notes do not pass current in the different national areas. In the absence of a universally acceptable note or credit currency (such as only a unified international banking system can provide) the inhabitants of separate countries must naturally refuse to accept payment in other's notes or cheques or at best put different valuation on the money of the foreigners. The object of the present chapter, therefore, is to explain the complicated business of exchanging currencies otherwise called '*Foreign Exchanges*.' The volume of international transactions now-a-days is so great that a slight variation in the value of money or a slight delay in payment usually causes considerable inconvenience and loss to the people engaged in trade and commerce. The subject is, therefore, well worth a detailed study.

**Meaning of Foreign Exchange.** Foreign Exchange may be defined as a system by which

traders of different nations discharge their debts to one another. It is a branch of finance whereby the citizens of one country can acquire the means of making payments to the inhabitants of other countries and the term is usually confined to those payments which are affected by means of credit instruments and / or by the actual transmission of gold. Hartley Withers has defined it as "*The Art and Science of International Money-changing*."<sup>1</sup> On the Art side it is concerned with the instruments of exchange and the institutions through which they are negotiated and on the Science side it is a study of the rate of exchange and the numerous problems connected with it. To sum up, the expression "Foreign Exchange" is used to refer to (1) that class of written orders to pay money, legally known as bills of exchange, which are used so much oftener than money itself, as a means of making payments or settling indebtedness between distant places<sup>2</sup>; (2) to the price at which these documents are exchanged or the rate of exchange; and (3) to institutions (*e.g.* banks, stock exchange, cotton exchange, etc.) through which these transactions are conducted.

**Kinds of Bills of Exchange.** Generally speaking there are two types of Bills of Exchange—the

1 Escher has defined it as "the business of buying and selling orders for the payment of foreign money at a foreign point"—*Foreign Exchange Explained*—p. 1.

2 Other methods of remitting money are :—

1. Export of gold ;
  2. Bank Drafts in a foreign currency (*i. e.* in the creditor's currency) ;
  3. Bank Drafts in the home currency (*i. e.* in the debtor's currency) ;
  4. Interest coupons payable in a foreign country ;
  5. The debtor himself drawing on a balance in a foreign bank.
- See Richard—*Groundworks of Economics*—pp. 244-45.



'foreign' or 'outland' bills which are drawn in one country and payable in another and the 'inland' bills drawn and payable within the same country.

**The Foreign Bill of Exchange.** The foreign bill of exchange is the customary form of making international payments. It is defined by law as "an unconditional order in writing addressed by one person to another, requiring the person to whom it is addressed to pay, on demand or at a fixed or determinable time, a sum certain in money to, or at the order of, a specified person or to bearer." Its usual form is this:—

£ 100 London 1st. April, 1935.  
*Sixty days after sight, pay to James Wilson or  
 order, the sum of One Hundred Pounds. Value  
 received.*

*A. B. Seller.*

To

*C. D. Buyer, New York.*

In this example, A. B. Seller is the 'drawer', C. D. Buyer is the 'drawee' and James Wilson the 'payee' to whom £ 100 have to be paid by the drawee two months after the date of the bill.

The words "Sixty days' after sight" are particularly significant. They confer a valuable privilege upon the drawee. He may merely draw two parallel lines across the bill of exchange (B/E) and write "accepted" between them with his signatures to postpone his liability for actual payment till after the period allowed has expired. The bill thus '*accepted*' becomes a *Negotiable Instrument*. If the drawer or the holder of the bill cannot wait

<sup>1</sup> It may also be 10 days, 30 days, 90 days or any other length of time,

till then, he can sell it to a banker or a bill-broker for an amount less than the face value by the rate of interest for the period for which the bill is to run. The amount thus deducted is called '*discount*' and the process is called '*discounting*'. The banker or the bill broker, if he stands in need of money, may have his once-discounted bill '*re-discounted*' at any other institution which is usually a Central Bank.

**Kinds of Bills.** Bills payable within ten days are called "short bill"; those running for longer periods are known as "long bills". If the drawer grants no accommodation and insists on the bill being honoured on presentation, the bill of exchange is called a "sight bill". Bills payable sometimes hence are known as "usance" bills.

**Working of a Bill of Exchange:** To understand the working of exchange bills, let us assume that a merchant A in Delhi buys medicines from a merchant B in London and that another merchant C in London owes the *same amount* of money to a merchant D in Delhi in respect of jute imported by him. Now, B the English creditor, would not accept Indian rupees nor would D, the Indian creditor, accept pounds sterling. A and C, therefore, would both have to purchase gold and send it across the ocean in opposite directions and incur heavy cost of transportation and insurance into the bargain. To avoid all this trouble and expense, B the English creditor draws a bill for the amount due to him which A the Indian debtor accepts. B has now the right to money in India. He sells his right to C the English debtor who wants to pay money in India. C sends the bill to D who, by means of his bank, collects the money from A. A simple diagram will show how this is done:—

## LONDON

sells the bill to

B  
(Creditor)C  
(Debtor)

← Pounds →

Medicines

drawn on

who sends it to

Jute

Rupees →

pays the bill when due to

A  
(Debtor)D  
(Creditor)

## DELHI

**Bank Drafts.** Here we have assumed that the amount of money involved is the *same* but in actual practice this is hardly the case. Debtors have, therefore, to go to bankers and bill-brokers and obtain bills of the exact value which they have to remit. These bills of exchange *made to order* are called Bankers' Drafts. A bank draft is an order of one bank upon another to pay money to an individual, firm or corporation. Each bank makes a practice of keeping deposits with banks in other cities in order that they may be able to "draw" upon them.

**Advantages of Bills of Exchange.** The bills of exchange give the owner the right to receive a specified sum of money at a given place and time and this right can be bought and sold. They provide a cheap and convenient way of paying international debts and enable merchants to be paid for their goods in the money of their own country. They help in economising the use of gold and in saving much expense and inconvenience

which would become inevitable if foreign payments were made through the transmission of precious metals.

**Inland Bills of Exchange—Hundis.** The credit instrument usually employed for the payment of money within the same country is called a '*hundi*'. *Hundi* is a Persian word which literally means 'to collect'. Ordinarily, the word stands for all instruments of exchange drawn in vernacular. Dr. L. C. Jain defines a *hundi* as a "written order—usually unconditional—made by one person on another for the payment, on demand or after a specified time, of a certain sum of money to a person named therein."<sup>1</sup> It bears an impressed stamp and is usually drawn up in the vernacular '*Mahajani*'. The *muddati hundis* (deferred or usance bills) generally run for an odd number of days, that is, for 41 days in Benares, Bombay, Lucknow, etc., for 61 days at Delhi, Farrukhabad, etc., and for 121 days at Lahore and Multan. Some are drawn payable on the 11th and 21st day of issue. The sight bills are called *darshani hundis*. These documents start with salutations and words invoking divine blessings. The name of the payee and the amount (half and twice of which are also mentioned) are explicitly stated no less than five times in the actual body of the instrument. In the event of the first copy of the bill called '*khoka*' being lost, a second copy or the '*penth*' or a third known as a '*parapenth*' are drawn but in such a way as to avoid duplicate payment. The acceptance of a *hundi* is not entered on its face. Only the particulars of it are entered into the drawee's book. The rate of discount is known as '*hundiya*'. It varies with the state of trade and the financial standing of

1 *Indigenous Banking in India*.—p. 71

the parties. The dishonouring of the *hundi* is very rare and every dispute arising out of the *hundi* transaction is immediately settled by the local panchayets of indigenous bankers.

### Form of the Hundi.<sup>1</sup>

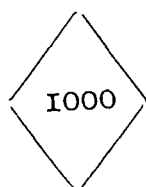
SHRI GANESH JI SAHAI.

Om Sri Sada Salamati hove. Messrs. Rawley Brothers Jog Likhi Lahore Seti. Lala Ramchand Mool Chand di ram ram wachni. Aprant hundi nag ek tusade upper kitti. Rupaya 1000 akhri ek hazar nimen rupaya, Rupaya Panch Saw tis de dugne dewane. Kanak bheji tusade nam. Chet di das Samwat 1971. Din 60 pichchee Shah Jog rupaya Rokari chalan bazar chehra shahi bhar dewne. Chaukas ho kar dam dewne. Hundi miti chet di das.

Daskhet RAM CHAND MOOLCHAND.

On the back of the note will be written :—

Rupaya ek hazar  
nimen panch saw  
tiske d u g n e  
dewane.



Messrs. Rawley Bros.  
Export Agents,  
KARACHI.

Put into English this reads something like the following :—May the blessed Ganesh protect. May you live in peace and happiness. Addressed to Messrs. Rawley Brothers from Lahore. Greetings from L. Ram Chand Mool Chand. Drafted this hundi against you for 1000 rupees (one thousand)

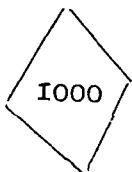
<sup>1</sup> Copied from Thomas and Aggarwal—*Elements of Economics*. p. 397.

half of which is 500 (pay double of that). Wheat despatched to your address this tenth of Chet Samwat 1971. Money must be paid after 60 days in the current coin of the realm of the Shah or a banker. Pay the amount after making enquiries and taking precautions according to the Bazar practice.

Hundi drafted on 10th Chet 1971.

(Sd.) RAM CHAND MOOL CHAND.

Rupees one thousand, half of which is five hundred. Pay double of that.



To  
Messrs. Rawley Bros.  
Export Agents,  
KARACHI.

**The Exchange Banks.** The institutions through which foreign bills of exchange are bought and sold are called Exchange Banks. They have their branches in many commercial centres of the world and therefore they can give full facilities for the transfer of goods and money from one place to another. The exchange banks perform all the functions of an ordinary joint stock bank<sup>1</sup> and, in addition, employ a large part of their funds in purchasing or discounting bills of exchange particularly those drawn against export trade. These bills are of three kinds :—

1. Documents for acceptance (D. A.)
2. Documents for payment (D. P.)
3. Documents for delivery (D. D.)

The D. A. bills enable the importers to get the goods from the warehouse of the bank on their

1 See chapter on Banks and Banking.

accepting the bill and the holders of the drafts have to rely exclusively upon the personal credit of the drawee and the acceptor until such time as the bills become due for payment—60 to 90 days hence plus the days of grace. The D. P. bills, against which the documents will only be given up on payment, give better security to the holders and are drawn on ordinary merchants who cannot obtain accommodation from foreign exporters. The D. D.'s are rare. They confer an authority to surrender the Bill of Lading<sup>1</sup> before acceptance takes place.

The Indian branches of exchange banks discount D. A. bills in India and when hard pressed for money they get them re-discounted in the London Money Market. They also transfer surplus funds to India for financing the foreign trade partly by selling sterling<sup>2</sup> to the Government of India and partly by shipping to India sovereigns and bullion in large amounts.

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## SUMMARY

**Foreign Exchange.** When people of a country trade with foreigners they must pay for their imports and receive payments for articles exported by them. There is thus a constant exchange of currencies and the study of the various aspects of this international money-changing is called Foreign Exchange. In this chapter, only the documents of exchange and the institutions through which they are negotiated are discussed.

**Kinds of Bills of Exchange.** The most important instrument of exchange is the Bill of Exchange. It is of two kinds—the 'foreign' or 'outward' bill which is drawn in one country and payable in another and the 'inland' bill drawn and payable within the same country.

1 It is a memorandum of goods shipped on board of a vessel signed by way of receipt by the master of the vessel.

2 See Chapter VIII.

**The Foreign Bill of Exchange.** It is a written request or an order from the drawer to the drawee to pay a certain sum of money either to himself or to some other man stated in the bill (and called the payee) on demand or sometimes hence. Bills payable on presentation are called 'sight' bills. Those which are payable after some time are called 'short' or 'long' bills according as they are payable within ten days or later respectively. The 'long' and 'short' bills are presented to the drawees who 'accept' them by drawing two parallel lines across the face and writing the words 'accepted' with signatures in between. After being 'accepted' a bill becomes a 'negotiable instrument'. It may be held till maturity or, if the then holder of the bill is urgently in need of money, he may sell it to a bank in which case he will get the face value of the bill minus the interest for the period the bill is to run. This deduction made by the bank is called 'discount' and the process is called 'discounting'. In case the bank purchasing this bill stands in need of money, it can have it discounted once again at the Central Bank—the process being called 're-discounting'.

**The Working of a Bill of Exchange.** The working is simple. In every country there are importers (debtors) and exporters (creditors). The creditors of one country draw bills on their debtors in other countries and have them duly accepted by them. These bills they sell to the debtors of their own country who are anxious to send money abroad. The debtors (importers) send these bills to their creditors in other countries who collect them from the debtors of their own country (who had originally accepted the bills). In actual practice, the amounts of bills may differ and the importers (debtors) may not be able to find the creditors who may be willing to sell them their bills. Hence, all bills are purchased through bankers and bill-brokers who draw bills of the exact value one wants to remit. These bills of exchange made to order are called Bankers' Drafts.

The bill of exchange is a *cheap* and *convenient* method of remitting money. *A single bill cancels two transactions and enables people to be paid in the currency of their own country.*

**Inland Bills of Exchange—Hundis.** A hundi is an indigenous instrument of remitting money. It is usually drawn up in *Mahajani*. The *mudatti hundis* (usance bills) often run for odd number of days and can be discounted and re-discounted



like foreign bills of exchange—the deduction in this case being called *hundiya*. The sight bills are called *darshani hundis*. Unlike foreign bills, a *hundi* begins with salutations and words invoking Divine blessings. The name of the payee and the amount (half and twice of which are also stated) are mentioned no less than five times in the body of the bill. A *hundi* is seldom dishonoured and all disputes arising out of *hundi* transactions are settled by the local panchayets of indigenous bankers.

A specimen of a *mudatti hundi* is given.

**The Exchange Banks.** These banks perform all the functions of an ordinary bank and, in addition, deal in (purchase, sell, discount, and re-discount) foreign bills of exchange which are of three kinds—D. A's (or Documents against Acceptance) which enable the importers to get the goods from the banks merely on accepting them; D. P's (Documents against Payment) which insist on payment being made before the delivery of goods is made and D. D's (Documents against Delivery) which confer an authority to deliver goods before acceptance takes place.

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### QUESTIONS

1. What is meant by Foreign Exchange?

[Delhi Inter. 1929].

2. What is a foreign bill of exchange? When is it said to be discounted?

Show how by means of a bill of exchange a sale of goods to a merchant in London and a sale to a merchant in Delhi by a merchant in London, may be liquidated without sending specie from one country to another.

[Agra B. A. 1934 ; Delhi Inter. 1928 and 1930]

3. State what you know about Hundi. Give a specimen form of a Hundi used in your locality and explain its meaning as clearly as you can.

[U. P. Inter. 1930]

4. Describe the part played by the Hundi in the banking and the commercial systems of India and compare it with the corresponding instruments of credit in other countries.

[Punjab B. A. 1931]

## CHAPTER VIII

### FOREIGN EXCHANGES—(*Continued*)

#### THE RATE OF EXCHANGE

Having studied the objects and functioning of exchange instruments and institutions, it remains for us to explain how the price of the bills of exchange is determined. In other words, we have to study the methods of determining the rates of exchange between different countries and the causes affecting their fluctuations from time to time.

**Definition of the Rate of Exchange.** The rate of exchange between two countries is the price paid in the home country for one unit of the money of the foreign country payable in that country or, more simply, “the price of the money of one country expressed in the money of the other.”<sup>1</sup> It is generally quoted in two ways :—

1. One unit of the foreign currency to so many units of the home currency, or

2. A certain number of units of foreign currency to one unit of home currency.

Thus we can say £ 1=Rs. 15, or Re. 1= $\frac{1}{15}$  £1, i. e. 1s. 4d.

#### Methods of Determining the Rates of Exchange.

Since different countries of the world have different monetary standards,<sup>2</sup> it is but natural that the rates

1 Escher—*Foreign Exchange Explained*—p. 1.

2 See Chapter IX.

of exchange between them should be fixed by different considerations. For the sake of simplicity, let us classify them in four categories.

The *first* category includes all countries on the gold standard. Their principal currency consists of gold coins of different sizes and denominations and the rate of exchange between them is determined by finding out how many coins of one country can be made out of the metal contained in one coin of the other country. This method of ascertaining the rate of exchange by comparing the metallic contents of the currencies of different countries is called the Mint Par Theory of Exchange. A simple example will make it very clear. Suppose we want to find out the rate of exchange between England and America—*assuming both of them to be on the gold standard.*

Now, we know that the weight of the British

Sovereign (£) .. .. = 113.0016 grains of fine gold

But, because the weight  
of the American golden  
eagle which is equal to

10 dollars (\$ 10) .. .. = 232.2 grains of fine gold

The weight of one

dollar (\$ 1) .. .. = 23.22 grains of fine gold

Therefore, £ 1 .. .. =  $\frac{113.0016}{23.22} = \$4.8665$ .

Hence, the London—New York or Sterling—Dollar

Mint Par of Exchange is 4·8665 (£1—\$4·8665).<sup>1</sup>

Similarly, the mint par of exchange between the English and German currencies can be deduced as follows :—

X marks	..	..	=£1
£1	..	..	=240d
934·5d	..	..	=1 ounce standard gold
12 ounces standard gold			=11 ounces fine gold
1 ounce fine gold	..		=31·103496 grains of fine gold
1000 grains fine gold			=2790 marks

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1 It should be noted that the same method would also apply to two countries on the silver standard if the price of silver is the same all over, as well as to those one of which has a gold standard and the other a silver standard provided the value of silver in respect of gold remains fixed. We can also find out the *theoretical* mint par of exchange between two countries—one of which possesses a gold standard and the other gold exchange standard provided the metallic contents of the latter currency are known. For example, the rate of exchange between England (assuming it to be on the gold standard) and India, is calculated thus :—

The rupee contains 165 grains of fine silver or  $\frac{165}{480} = \frac{11}{32}$  ounces.

But 37 ounces of fine silver = 40 ounces of standard silver

∴ the amount of standard silver contained in the

$$\text{rupee} = \frac{11}{32} \times \frac{40}{37} = \frac{55}{148} \text{ ounces.}$$

Now, if the price of standard silver be assumed to be 43d per ounce,

the value of silver contained in the rupee will be  $= \frac{55}{148} \times 43 = 16\text{d.}$

But, if the price of silver is 48d per standard ounce, the price of silver contained in the rupee will be  $= \frac{55}{148} \times 48 = 18\text{d.}$

Thus, now that the exchange between India and England is Re. 1=18d, the melting point of the rupee would be reached as soon as the price of silver rises to 48d per standard ounce. In other words, if exchange between India and England is left free and if the price of silver in the market is 48d per ounce, the rate of exchange would be Re. 1=18d.

$$\therefore X \quad \dots = \frac{240 \times 11 \times 31 \cdot 103496 \times 2790}{934 \cdot 5 \times 12 \times 1000}$$

$$= 20 \cdot 42945 \text{ marks.}$$

Thus, every 20·43 marks of German gold money contain just so much gold as would be required to coin £1 sterling, or £1=R. M.<sup>1</sup> 20·43.

By similar comparisons the Mint Pars between any two countries using the same metal as their standard of value can be calculated, but it must be understood that any Mint Par is merely a theoretical measurement of the value of one standard coin in terms of another standard coin. It takes no account of practical variations in the weight or fineness of actual coins due to wear and tear and is a purely arbitrary basis of comparison. It may not be possible to obtain gold coins in either country and the free import or export of gold may not be permitted, so that actual transference of coins would be impossible, but as long as the existing coinage laws of the two countries remain unchanged the Mint Par between them will also remain unaltered as it is a theoretical rate of exchange based on the laws themselves.

Even when gold is available, the traders prefer to settle their debts through exchange bills purchased from bankers and brokers. If the bills drawn on a particular country are exactly equal to the bills drawn by this country upon foreigners, there is no difficulty. The debts are offset by credits. Such a condition, however, seldom exists. In actual practice, sometimes a country imports more than what it exports and sometimes its exports largely exceed its imports, so that the price of the bills of exchange vary in accordance with their

1 R. M.=Reichmarks.

supply and demand. Let us take a concrete example to show how it all happens. A in New York (America) has sold a consignment of steel to E in London (England). Before its being despatched from New York, the steel becomes represented by a Bill of Lading on the strength of which A can get payment from a bank even before its arrival in London. A draws a bill of exchange upon E for the amount; that is, he instructs E to pay a definite sum at a definite time. It may be, according to the terms of the bargain, payable 'at sight' or in three months. This bill of exchange and the Bill of Lading are sold by A to a New York banker who sends them to his London agent from whom E obtains the Bill of Lading—enabling him to get the steel—by accepting or by actually paying the bill (depending upon whether the bill was a D. A. or a D. P.). The New York banker thus has at his disposal credit in London.

Now, suppose another businessman L, in U.S.A. owes money to somebody in England. He goes to the New York banker (who has credit in London) and wants a draft payable in London. The banker knows very well that if his client did not get the bill he shall have to ship the required amount of gold and incur the cost of transportation and insurance into the bargain, that is, in addition to spending \$ 4.866 for every £ 1, he will have to spend .024 cents per sovereign. He, therefore, quotes for his bill any price between \$ 4.866 and \$ 4.89 ( $4.866 + .024$ ). He cannot demand a price higher than \$ 4.89 (for every £ 1) because otherwise, L, the American debtor will think it worth his while to undergo the risk and expense of shipping gold. This highest point to which the price of bills can go is called the *Upper Specie Point*. It is found by adding the cost of

insurance, commission and freight to the mint par. It may also be called the 'outward' or 'export' gold point because, beyond this limit, so far as the American is concerned, gold will be exported.

It should be remembered that the price of the bill will seldom be exactly \$ 4.89. It will vary between \$4.866 and \$4.89 depending upon the supply and demand of bills.

Now, imagine that there is a little or no demand for bills on London in America. What should the New York banker do to transfer the money, lying to his account in London, to America? He will have to have it converted into gold and shipped to New York in which case, after *deducting* the cost of transportation and insurance, he will get \$ 4.842 (4.866 *minus* .024 cents) for every pound deposited to his account in London. This is the maximum that he can get. So he will try to persuade some stray American debtor to purchase a bill from him and offer to charge from him a price even *less* than the mint par but not less than \$ 4.842. Thus we find that, *if the demand for the bills of exchange is less than their supply*, their prices fall. The lowest price to which it can fall is determined by subtracting the cost of commission, insurance and freight from the mint par and is called the '*Lower Specie Point*'. From the point of view of the Americans, it may be regarded as the 'inward' or 'import' gold point because if the price exceeds this limit gold will certainly be imported into U. S. A.

To sum up, the rate of exchange between two countries on the gold standard is determined by the Mint Par and the rate thus determined fluctuates between the upper and lower specie points

depending upon the extent of mutual indebtedness measured by the supply and demand of bills.

In the *second* category we put two countries one of which is on a gold standard and the other on an inconvertible paper currency standard. This case is slightly complicated owing to the inability of the country on the paper standard to discharge its obligations in gold. The people of such a country will have to depend *entirely* upon the bills of exchange and the holders of such bills (bankers and bill-brokers) will take full advantage of their helplessness. They will not be bound by the specie points; infact, if the demand for foreign remittance is very keen, they will charge a price much higher than the upper specie point. In the previous example, if the American debtors did not have the alternative of sending gold to London, the New York banker would have charged from them much more than \$ 4.89—say, \$ 5 or even \$ 6 (for every £ 1 to be remitted to London) if the demand for his bills was really intense. The other country—on the gold standard—however, will not be affected because, so long as the people have the option of sending gold abroad, the ratio of exchange will be prevented from deviating from the par by more than the cost of transportation and insurance.

The *third* category is typical of war conditions. It comprises all countries on inconvertible paper currency standards. Here, neither country enjoys the privilege of sending gold to and fro. The holders of bills of exchange are, therefore, in an excellent position to charge whatever price they think reasonable for their bills. They demand higher prices when the demand is great than when the demand is small and very often these prices overstep the limits set by the specie points.



**The Balance of Trade Theory.** It is thus clear that the price of exchange bills depends upon their number and since they are created in response to the requirements of trade, the rate of exchange may safely be held to be determined by trade conditions. If a country exports more than what it imports, the balance of trade is in its favour. It has a greater claim upon the currency of other countries than those countries have upon its own. The money of this country will, therefore, be at a *premium*, that is, it would command greater value in respect of the currency of the other country, and the rate of exchange will be clearly *favourable*<sup>1</sup> to it. Conversely, if the balance of trade is unfavourable to a country, its currency in respect of the currency of another country will be at a *discount*, that is, it will command less exchange value, and the rate of exchange will be against it. This is the famous Balance of Trade Theory.

**The Balance of Accounts.** It will be noticed that we have all along assumed that payments are made for *goods* only but in modern times there are innumerable other transactions among trading nations *which are not recorded* but for which payments must be made.<sup>2</sup> A true *balance of accounts* between them should be struck by including all the *total credits and debits*, that is, all aggregate visible as well as invisible imports and exports.

**Visible and Invisible Imports and Exports.** By *visible* imports and exports we mean those goods

1 For a clear conception of favourable and unfavourable exchanges read *The Foreign Exchange Market* by H. F. R. Miller, pp. 45-46.

2 "There are", says Hartley Withers, "many more exports in heaven and earth than are dreamt of by the philosophy of the Board of Trade."—*The Meaning of Money*—p. 190.

and bullion for whose movement from one country to the other proper statistics are kept. The terms *invisible* imports and exports refer to those items for which *no records are kept*—the former is applied to such *unrecorded* items for which a country has to pay and the latter to those which entitle her to receive payment. Some of the items that should be included in a country's balance sheet are :—

1. *Foreign trade of the country* including trade in merchandise and treasure. A country is a debtor to the extent of its imports but has to be paid for its exports.
2. *Loans* offered or received from abroad. While a loan is being carried out the nation contracting the debt is the creditor and the nation which advances the loan is the debtor. The position is, however, reversed at the time of the payment of the interest or the re-payment of the principal.
3. *The earnings of the nationals* of a country doing business abroad, so far as they are remitted to the mother country, count towards the credit side of that country.
4. *The remittance of money for benevolent purposes.* The country receiving the charity becomes a creditor while the country sending the donation becomes a debtor.
5. *The expenditure of a nation's government abroad* will make it a debtor to that extent and, conversely, the expenditure of other governments in a country will make it so far a creditor.

6. *The payment of tributes or indemnities obviously makes the paying country a debtor and the receiving country a creditor.*
7. *The expenses of students and tourists residing or travelling abroad make their country indebted to that extent.<sup>1</sup>*

**The Balance of Trade of India.** The following table gives an idea of the visible balance of accounts of India during the last three years as well as the average of ten years immediately preceding the War. For the sake of simplicity, figures have been expressed in crores of rupees and amounts less than 1 lakh of rupees have been omitted.

#### BALANCE OF TRADE OF INDIA

	Pre-war average.	(In crores of rupees)		
		1934-35	1935-36	1936-37
Exports of Indian merchandise (private) ..	+ 2.19	+ 1.52	+ 1.61	+ 1.93
Re-exports of foreign merchandise (private) ...	+ 5	+ 4	+ 4	+ 6
Imports of foreign merchandise (private) ...	- 1.46	- 1.32	- 1.34	- 1.25
<b>BALANCE OF TRADE IN MERCHANDISE (PRIVATE)</b> ...	+ 78	+ 23	+ 31	+ 73
Gold (private) ...	- 29	+ 53	+ 37	+ 28
Balance of transactions in treasure (private) ...	- 36	+ 53	+ 37	+ 15
<b>Total visible balance of trade...</b>	+ 42	+ 76	+ 67	+ 92

1 "In a foreign exchange market, demand (for money) arises not only from the importation of goods, services or securities, but also from the service of political and other debts, from desire to speculate in foreign currencies, from desire to travel, from the purchase of lands, houses and factories abroad, from long and short loans to foreigners, from presents and other remittances, and from a desire to export one's capital. Similarly, supply results not only from actual export of goods, but also from the sale of securities, from the sale of financial, shipping and personal services, from dividends earned abroad, from short and long term borrowings, and from speculative purchase of currencies by foreigners (for a rise or for safety)." *The Problems of Foreign Exchange*—L. L. B. Angas, p. 18.

	Average of 10 pre-war years.	(In crores of rupees)		
		1934-35	1935-36	1936-37
Purchase of sterling by the Reserve Bank of India. ...	-41	-50	-46	-71
Sales of sterling by the Reserve Bank of India. ...	—	—	—	—
Transfers of Government securities ... ..	—	—	—	—
Interest Drafts on India in respect of Govern- ment of India securities	—	—	—	—
BALANCE OF REMIT- TANCE OF FUNDS ...	-43	-50	-46	-71
TOTAL VISIBLE BALANCE OF ACCOUNT (PAY- MENTS) ... ..	—	+26	+20	+21

The table shows that the visible balance of trade, as measured by statistics of private merchandise and treasure, in 1937 was about Rs. 92 crores as compared with Rs. 67 crores in 1935-36. The improvement of Rs. 25 crores was the combined result of an increase of Rs. 35 crores in exports of Indian merchandise and a decline of Rs. 10 crores in the imports of foreign merchandise. There was also a fall of Rs. 9 crores in the export of gold.

The net balance of remittance of funds came to about Rs. 71 crores and the total visible balance of accounts for 1937 was about Rs. 21 crores *i.e.*, only one crore more than in the preceding year but five crores less than in 1934-35. The figures relating to remittances include the more important Government transactions but do not take into account (a) net payments in India of British postal orders and of foreign money orders of countries which settle their accounts through London, and (b) Government transfers on account of Iraq and Mauritius.

The balance of account shown in this statement is not actually a complete record of the state of affairs as there are many items for which no statistics are available and the volume of which it is not possible to estimate such as remittances for domestic expenditure in England, investments abroad, etc., on one side of the account and remittances for investment in India, expenses of tourists, etc., on the other. The statement, therefore, contains only those factors for which Government statistics are available. The League of Nations has, however, attempted to estimate the total credits and debits (including goods, services and gold) of the member countries. The following table gives an idea of the estimated balance of payments of British India for 1930-33.<sup>1</sup>

1 *Balance of Payments*—pp. 113-115.

Items.	Rs. (000,000,s)									
	Inward or credit movements (exports)					Outward or debit movements (imports)				
	1929-30	1930-31	1931-32	1932-33	1929-30	1930-31	1931-32	1932-33		
<i>I. Merchandise.</i>										
1. Merchandise.	3,204.6	2,282.8	1,630.4	1,372.1	2,630.3	1,865.5	1,350.3	1,366.5		
2. Adjustments on account of :—										
(a) Land frontier trade.	200.0	160.0	110.0	90.0	180.0	150.0	100.0	80.0		
(b) Wrong valuation.	..	..	..	..	56.2	56.0	67.3	68.5		
<i>II. Interest and dividends.</i>										
3 Interest and dividend on long term capital.	30.8	21.6	9.7	6.3	359.0	359.0	360.1	353.0		
4. Interest on short term capital.	12.2	1.6	2.8	2.6						
<i>III. Other Services.</i>										
5. Shipping freight.	..	..	..	..	..	..	..	..		
6. Port fees.	28.0	25.0	24.0	22.5	..	..	..	..		
7. Commission, insurance brokerage.	..	..	..	..	12.0	12.0	10.0	10.0		
8. Post, telegraph and telephone.	1.4	1.2	..	..	0.9	0.9	1.0	1.2		
9. Tourists, diplomatic expenditure, etc.	..	..	..	..	45.0	45.0	40.0	40.0		
10 Repairs in cash.	3.3	3.2	0.8	..	..	..	..	..		
11. Other Government receipts and expenditure.	114.6	85.0	90.8	88.3	269.5	215.6	244.0	221.2		
<i>IV. Gold.</i>										
12. Gold coin and bullion.	0.1	4.9	607.7	668.4	142.3	132.5	28.0	13.2		
Total ..	3,595.0	2,585.3	2,476.2	2,248.2	3,695.2	2,836.3	2,200.9	2,153.4		

**Exports Pay for Imports.** Taking the exports and imports in the broad sense, we may say that the exports pay for imports for, in the *long run*, no country can afford to import more than what it exports or export more than what it imports. In other words, if something of value is bought from foreigners, something of equal value has got to be sold to them. The money value of exports and imports must ultimately balance. "If an Englishman buys an American car instead of a British one, American dollars will sooner or later have to be bought to pay the American manufacturers. Pounds, infact, will be spent on dollars. The American manufacturer might, it is true, temporarily accept payment in pounds, but eventually he himself will want to convert these pounds into dollars. Thus, there will arise sooner or later the problem of finding someone who will part with dollars in exchange for pounds; that is, spend dollars on pounds.... But the only person who will permanently spend dollars on pounds is someone who wants to buy British goods, *i. e.* to import from Great Britain. Indeed, in the long run, any pounds initially spent on dollars (for example, to buy imported American cars) must sooner or later be re-spent on British exports. Eventually, infact, exports must equate, in sterling value, with English imports."<sup>1</sup> Normally, exchange of goods for goods or services takes place and the balance is adjusted through the remittance of specie. The paying out of specie or receiving it affects the supply of money and produces such changes in prices as lead to the equalising of imports and exports. If, for example, trade is on the whole favourable to America, it stands to reason that prices in U. S. A. are comparatively low; that it is a good country to buy from and a

1 *The Problems of the Foreign Exchanges*—pp. 18-19.

bad country to sell to. Consequently, money will flow into America and by raising prices remove the very cause that had made America a creditor country. The whole position has been beautifully summed up by Gide thus: "There is a sort of automatism in the balance of accounts that tends to restore the equilibrium whenever it is disturbed—in much the same manner that regulators on steam engines tend always to maintain a uniform speed. The current of trade cannot for ever continue in one direction any more than the tide of the sea; sooner or later it must change, and after metallic money has been taken out of a country there are natural forces which tend to bring it back again."

It must also be borne in mind that the terms imports or exports are used in their wide sense to embrace *all* visible as well as invisible items going to and coming from *all* other countries to the country whose balance-sheet we want to strike. Moreover, the balance of trade is never settled within any period of twelve months like that of the official year which is usually made the basis of our calculations but if longer periods are taken the adjustment will be seen to have taken place.

To avoid further digression, let us recall the main point of our present discussion, namely, that according to the balance of trade theory, the rates of exchange between countries on inconvertible paper currency standards fluctuate according to the state of mutual indebtedness which we have called the balance of accounts.

There is, however, an alternative explanation which, since the last War, has assumed importance.

1 Principles of Political Economy—p. 300

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importance. According to this view, *inflation* is the principal cause of changes in the rates of exchange. Since this theory is based on differences in purchasing power caused by inflation in different countries, it has been called the Purchasing Power Parity Theory.

**The Purchasing Power Parity Theory.** If there are two countries on a gold basis and the unit of currency in each of them contains 10 grams of gold, then one unit of the currency of one will be equal to one unit of that of the other or the par of exchange will be unity. If both of them resort to inconvertible paper money and the former doubles the quantity of currency in circulation, while the latter quadruples it, the price level in the former will be half of that of the latter. The rate of exchange, therefore, will be 1:2 in accordance with their price levels. The rate of exchange obtained by comparing price levels of two countries is called the purchasing power parity.

The essence of this theory<sup>1</sup> is that we judge the value of a foreign currency to us by its command over goods and services. Purchasing power is indicated by the general level of prices so that if prices in a foreign country are higher compared with our own the money of that country will not go very far and we, therefore, expect to get more of its money in exchange for our own. In other words, the value

<sup>1</sup> Cassel, the founder of the theory, has explained it thus — "When two currencies in two countries have been inflated, the new normal rate of exchange will be equal to the old rate multiplied by the quotient between the degrees of inflation of both countries. There will, of course, always be fluctuations from these normal rates and, in a period of transition, these fluctuations are apt to be rather wide. But the rate calculated in the way indicated must be regarded as the new parity (or par of exchange) between the currencies. This parity may be called the Purchasing Power Parity as it is determined by the quotient of the purchasing powers of different currencies" — *The World's Monetary Problems*.

of the unit of one currency in terms of another is, in the long run, determined by the relative values of the two currencies indicated by their relative purchasing powers over goods and services.

Take, for example, the rupee-sterling exchange. Assuming that goods pass freely between India and England and that exchange is not artificially regulated, the rate of exchange between them, when the index number of prices in either country is 100, is Re. 1=18d. If, however, as a result of inflation, prices in England rise from 100 to 150 the purchasing power of the English currency falls relatively to the rupee which will now be equivalent to  $\frac{18 \times 150}{100} = 27d$ . If, on the other hand, Indian prices also rise, say from 100 to 200, the purchasing power of the rupee having fallen more compared to the depreciation of the sterling, the new rate of exchange ( $\frac{18 \times 150}{200} = 13\frac{1}{2}d$ ) will be more favourable to England.

Hence, "the purchasing power parity between any two currencies is obtained by multiplying the current index number of prices in the country in whose currency the figure is to be expressed by the pre-War par of exchange in order to make the two index numbers of prices comparable and dividing this result by the current index number of the second country."<sup>1</sup> This may also be reduced, for our present purposes, to the formula

$$\frac{\text{British Index Number} \times 18d}{\text{Indian Index Number}}$$

The equation can be approximately verified by

<sup>1</sup> Chablaini—*Indian Currency, Banking and Exchange*—p. 58 (Ed. 1932).

taking actual figures. The rate of exchange before the War was Re. 1=16d. During the War, when England created immense purchasing power by issuing inconvertible currency, prices went up from the pre-War par of 100 to 226 while in India the price level rose from 100 in 1914 to 178 in 1919 with the result that the new rate of exchange (Re. 1=20d) corresponded with the new rate calculated by the purchasing power parity theory, viz :

$$\frac{226 \times 16}{178} = 20.3d.$$

The Babington Smith Committee recommended the extraordinary rate of 2 shillings mainly on the ground that prices in India were considerably lower than prices outside. Similarly, the Hilton Young Commission recommended 18d rate because the prices in India *at that rate* were equal to the world prices.<sup>1</sup> The knowledge of the purchasing power parity theory was thus put to great advantage in solving some vital problems of Indian currency and exchange.

**Limitations of the Purchasing Power Parity Theory.** It should be remembered that calculation of the purchasing power parity depends upon index numbers of prices. Since index numbers are merely indications of *average* rise or fall of prices, the rates of exchange calculated by means of the purchasing power parity theory frequently deviate from the existing rates of exchange as the table below will show :—

1 See Chapter XII.

I Date.	II English Index Number.	III American Index Number.	IV Existing Ex- change Par = £1 = \$4.86	V Exchange deter- mined by Pur- chasing Power Parity.	VI Percentage deviation of Pur- chasing Par from existing parity (Ratio of IV & V)
June, 1932	97.4	86.4	3.67	4.32	17.7
September, 1932	106.0	91.2	3.44	4.18	21.5
January, 1933	91.5	87.4	3.45	4.65	34.7
June, 1933	95.6	93.1	4.11	4.74	15.4
January, 1934	97.1	103.4	5.09	5.18	1.7
May, 1934	95.4	105.6	5.11	5.39	5.4
June, 1934	94.9	106.9	5.01	5.48	8.7
September, 1934	96.6	111.2	5.00	5.60	12.0
December, 1934	97.4	110.2	4.94	5.51	11.5
January, 1935	98.4	112.9	4.91	5.58	13.6
March, 1935	97.5	113.2	4.77	5.65	13.4

To obtain correct results, therefore, great care has to be taken in the construction of index numbers especially in the matter of selecting a suitable basic year<sup>1</sup> and in the collection of accurate figures of wholesale prices of representative articles. Sometimes, the violent movements of exchange rates obstruct trade and prevent goods from finding their true level of prices. Sometimes speculation and anticipated inflation exert such a great influence on the exchange market that the actual rate prevailing at the time is very different from the one calculated by means of the purchasing power parity theory. For example, if inflation is expected in England, people may remove money balances from London and numerous pounds may be exchanged for francs. The extra supply of pounds and demand for francs thus engendered may temporarily depress the rate well below the true purchasing power parity. Deviation of the purchasing power parity from the existing rate will be particularly great if no allowance is made for transport charges and import and export duties

1 Cassel has suggested 1913 as the best.

If, for instance, England has an all-round export tariff of 10 per cent, or if France has an all-round import tariff of 10 per cent, the net external prices of English goods to Frenchmen will be increased by 10 per cent and the pound should theoretically be some 10 per cent cheaper in terms of francs than would be suggested by any index numbers which accurately measured true purchasing power parity. The theory is also defective because it ignores the effect of balance of accounts which are independent of internal purchasing powers and which, as has already been shown, materially affect the determination of the rate of exchange. In fact, the rate of exchange determined by the purchasing power parity theory is a *normal* rate, that is, an *imaginary* rate which will *tend* to be determined in the long period if other things remain unchanged. Other things, however, do not remain unchanged. There are day to day changes in the balance of trade and the rate of exchange moves with them. Hence, the normal, or the theoretical rate of exchange, is determined by the purchasing power parity but the balance of trade theory accounts for the temporary, seasonal or occasional changes in the rate of exchange. The *permanent* par itself is movable and will move only when there are differences in the price levels.

There is yet a *fourth* group of countries of which India is a true representative—countries between which exchange is not allowed to be determined by natural forces (i.e. import or export of specie) but is *artificially regulated* by the Government. In this case the dependent country has only a token coin functioning as a standard coin and its exchange value in terms of the currency of the mother country is artificially fixed. Owing to the difficulty of sending gold to and fro, there is

a danger of the exchange rising above or falling below the lower specie point and the Government has to control exchange operations by creating its own bills of exchange and by making them available to the public at fixed prices.<sup>1</sup> The presence of these bills in sufficient quantities keeps the exchange "pegged" within narrow limits. This system would break down only if the supply of these bills is restricted or if the prices at which the Government may offer them to the public are substantially increased. In the case of India before the War the token rupee was linked to the British sterling at Re. 1=16d and the exchange was maintained between the specie points (Rs. 4 $\frac{1}{8}$ d and Rs. 3 $\frac{29}{32}$ d) through the sale of Council Bills and Reverse Council Bills. Whenever, owing to a favourable balance of trade, the value of the rupee threatened to rise above the upper specie point the Secretary of State offered to sell to the English public bills drawn by himself on the Governor General-in-Council at any price varying between the par

<sup>1</sup> Many other methods may be adopted in times of emergency. During the war period, for example, the Sterling-Dollar exchange rate was "pegged" at £ 1=\$4.76 $\frac{1}{2}$ . At that time England had heavy payments to make to the United States in respect of food, munitions and raw materials supplied to herself and to the Allies. The heavy depreciation of the pound and the absence of counter-balancing exports would have caused the dollar exchange to fall far below the normal parity (\$4.86). The British Government, however, met the situation by fixing the exchange at an arbitrary figure, namely, \$4.76 $\frac{1}{2}$  and maintained it at first by limiting the imports of "non-essentials" into England and by raising dollar credits with private firms in New York which were sold at \$4.76 $\frac{1}{2}$  for £1 to British armament firms and importers of raw materials to enable them to discharge their American debts. The American and Canadian bonds held by residents in England were offered as securities—the holders of those bonds being compelled first by a very heavy income-tax and then by legislation to surrender these securities to the Treasury. The securities thus obtained were either sold in New York or deposited as collaterals for loans and thus formed an invisible export which paid for the import of food and ammunition by the Allies. When the supply of those securities had practically come to an end, the American Government raised loans in America for the British Government and therewith paid the United States exporters for the supplies of munitions and food sent to England and her Allies.

(Is. 4d) and the upper specie point (Is.  $4\frac{1}{8}$ d). The purchasers of these bills (called the Council Bills) sent them to their creditors in India who were ultimately paid by the Government of India or their bankers. It may be incidentally mentioned here that the Council Bills, apart from stabilising exchange, were regarded as a very convenient means of remitting Home Charges, i. e., the amount of money which the Government of India has to send annually to defray the expenses of the Secretary of State.<sup>1</sup> They also tended to (in theory at least) contract currency and lower prices in England and bring about a corresponding rise of prices in India. Similarly, in the event of exchange falling below the lower specie point, the sale of Council Bills was stopped and the Governor General-in-Council volunteered to sell Bills—called Reverse Council Bills—drawn by himself on the Secretary of State at prices varying between the par (Is. 4d) and the lower specie point (Is.  $3\frac{29}{32}$ d). Currency was contracted in India and by creating sufficient exchange bills (official) the exchange was prevented from deteriorating. Because the balance of trade was persistently in favour of India, the system worked satisfactorily only so long as the Government had sufficient money in the reserves in India to pay out the Council Bills and broke down during the war period when the funds ran out.

1 In respect of: —

1. Interest on the sterling debt of India;
2. Interest on the stock of the Government Railway Companies;
3. Pensions and furloughs of English officials payable in England;
4. Army effective and non-effective charges.
5. Purchases of stores in England on behalf of the Government of India; and
6. The cost of administration in England on behalf of the Government of India.

Even now-a-days the rupee has been "pegged" to sterling at Re. 1 = 18d, but the old method of Council Bills and Reverse Council Bills has been replaced by the system of *Purchase of Sterling*. Whenever the balance of trade is favourable to India and the rupee-sterling exchange rate threatens to rise above 1s 6½d (the upper specie point) the Government of India prevails upon the exchange banks to put their sterling resources in London at their disposal in exchange for money paid to them in India. This system was introduced in 1923-24 but was greatly extended in 1924-25 when the purchase of sterling was resorted to as a principal method of remittance, the weekly sales of Council Bills being started only when there was a great demand for them. The Hilton Young Commission recommended the purchase by competitive public tender and the publication of the weekly returns of remittances. Accordingly, since April 1927, the system of purchase of sterling in India by public tender has been inaugurated. Tenders are received on one day each week, usually on Wednesday, simultaneously in Calcutta, Bombay, Madras and Karachi and particulars of the amounts allotted are published on the following day in each of these places. Between the days on which the tenders are received, intermediates are on offer at the offices of the Reserve Bank of India at these places at a rate  $\frac{1}{32}$ d above the highest rate accepted on the previous day on which the tenders were received.<sup>1</sup>

The present system (like its predecessor) is an essential part of the complicated mechanism of foreign exchange and is also utilised for the annual remittance of Home Charges to the Secretary of State. It is preferred to the old system of Council Bills because it enables the Government to ascertain

<sup>1</sup> Also read Jathar and Beri—*Indian Economics*, Vol. II pp. 390-2 and the Reports of the Controller of Currency for 1924-27.



the factors much more accurately and promptly and to regulate the purchase of sterling much more satisfactorily with reference to the varying conditions of the market. It is also useful to the exchange banks who need not raise loans in England for they can always sell their sterling bills to the Government in India.

**Main Influences on the Exchanges.** We are now in a position to study the principal factors affecting the exchange values of currencies. These factors may be summarised as :—

1. *Short-term factors*—(a) Commercial.  
(b) Financial.
2. *Long-term factors*—(a) Currency and credit conditions.  
(b) Political and industrial conditions.

Let us deal with them one by one.

#### SHORT-TERM FACTORS.

*Commercial.* We have seen that the rate of exchange depends upon the demand and supply of exchange bills which are drawn in response to trade requirements and that the exchange tends to be favourable to a country which exports more than what it imports and unfavourable to a country whose imports exceed its exports—the words ‘imports’ and ‘exports’ being used in a very wide sense so as to include both visible and invisible items.

*Financial.* The development of banking and the ease and rapidity with which funds can be transferred from one centre to another have rendered banking and financial operations a most powerful factor affecting exchange rates. For

instance, if country A is exporting capital to country B, the supply of A's money offered against B's money will be increased and the rate of exchange will be favourable to B. Similarly, when it is feared that one currency or another will fall considerably in exchange value, quite large movements of capital may take place, not for long-term investment, but in the hope of making a gain or avoiding a loss on exchange movements. Movements of capital may also be due to Stock Exchange operations. It is a well-known fact that Governments and Municipalities often raise loans in foreign countries to meet the needs which the savings of their own people are not able to satisfy. Big industries likewise invite international subscriptions to their capital. If such capital stock and shares are subscribed for internationally, it follows that they must be marketable internationally and there are now many securities which can be dealt in on all the principal stock markets of the world. The creation of these international loans, payment of interest thereon, and their repayment etc., naturally lead to changes in the rates of exchange. For instance, "when a country gives loans to another, the loans have to be transferred into the foreign currency. Its demand for foreign currency increases and the rate of exchange moves against it. Similarly, when home investors buy foreign securities or home securities are sold by foreigners, the rate falls. But when the loans are being repaid; or when the foreigners buy domestic securities, the demand for home currency on their part rises and the rate of exchange rises."<sup>1</sup>

The Bank Rate also plays an important part in the determination of exchange rates. When it is high (in relation to other centres) foreigners send

<sup>1</sup> Sen & Das—*An Introduction to Economic Theory*, p. 432.

funds to that country to earn higher rates of interest. The demand for home currency rises and the rate of exchange moves up. Opposite happens when the Bank Rate is lowered.

Another financial operation, the results of which affect rates of exchange, is that of "*arbitrage in exchange*." The term "*arbitrage*" is applied to the simultaneous buying and selling of the same article in two or more markets. "*Arbitrage in exchange*" is, therefore, an operation in exchange by which speculators endeavour to profit by differences in the rates of exchange for the same currency ruling in two or more centres at the same time. They buy up currency in a centre where it is cheap and re-sell it in a centre where it is dear, the margin of difference constituting their profit.<sup>1</sup> The effect of such operations is to narrow down fluctuations in rates or to cause the world price of a currency to move in the same direction in all centres all at once, since a demand for any currency in a certain centre is met by transfers of supplies of that currency from centres where the demand is not so great and the price is consequently lower. Any excessive supply of a currency in one centre is similarly transferred to other centres where the supply is smaller and world supply and demand are thus set-off against each other.

### LONG-TERM FACTORS.

*Currency and Credit Conditions.* They exercise important influences on the rates of exchange.

<sup>1</sup> When such dealings are confined to two countries they are called "*simple* or *direct*" arbitrage but when they are carried out in a third currency between two centres or in four or more currencies between three or more centres simultaneously they are known as "*compound*" or "*two-point* (or *three-point* etc.) arbitrage.

If, for example, we know that the note-circulation of a country is increasing out of all proportions to its trade we may expect a fall in the purchasing power of money and a rise of prices. This must have an adverse effect upon the export trade of the country and consequently upon its exchange rate. A fall in the rate of exchange sets in motion forces which tend to bring prices down. Low exchange encourages imports and discourages exports and thus leads to the outflow of gold. To the extent gold goes out of the country there is a reduction in currency and credit and a corresponding fall in internal prices.

*Political and Industrial Conditions.* The national budget is a useful index to national finances. A country where expenditure is scrupulously adjusted to the income inspires universal confidence. Speculators in exchange buy up the currency of such country in anticipation of a rise in exchange due to increased prosperity. On the other hand, where it appears that a country is spending more than the state of its national prosperity justifies, fresh taxation will be inevitable. The speculators in exchange will sell the currency of such country in anticipation of a fall in its international value owing to reduction of exports (due to high prices) and to the general falling-off in national prosperity.

The political outlook in a country is also a potent factor both in exchange speculation and in the international movement of capital. A stable government, the strict maintenance of law and order, the protection of private wealth and property and the relation between labour and capital etc., decide whether capital should flow in or go out of a country and, therefore, whether exchange should be favourable or otherwise.

**EXCHANGE CONTROL.<sup>1</sup>**

Having studied the causes of exchange fluctuations, it remains for us to examine the need and modes of exchange control which, for our purposes, will include all governmental interference.

**Objects of Exchange Control.** The need of stable prices and exchange as a necessary condition for the development of trade and national prosperity has often been emphasised. The government must control exchange especially at times when it threatens to sink to levels at which trading with other countries will be impossible. Control of exchange may also be necessary to prevent a flight of capital and to prevent the gold resources of the central bank from falling very low—indeed, if possible, to increase them. As the strength or weakness of exchange depend upon the number of bills available for sale and purchase, the object of exchange control is to restrict the demand for foreign exchange and simultaneously to increase its supply.

**Methods of Exchange Control.**

1. *Regulation of Merchandise Movement.—Tariffs, Quotas and Licences.* Since it is the in-and-out movement of merchandise which primarily affects any exchange rate, it is only logical that the exchange should be controlled by regulating the

<sup>1</sup> The term has been variously defined. Paul Einzig, for example, has included under this denomination *all* interferences by monetary authorities on the exchange markets. See his *Exchange Control*, London 1934

Heilperin, on the other hand, believes that exchange control consists only in the centralisation of all dealings in foreign exchange in the hands of a public authority. See his *International Monetary Economics*, p. 238.

*The Report on Exchange Control*, submitted by a Committee composed of members of the Economic and Financial Committee of the League of Nations, Geneva, 1938, provides no explicit definition whatever.

amount of imports and exports. This is usually accomplished by imposing restrictive or even prohibitive duties on the import of certain goods and/or by offering subsidies, bounties or "drawbacks" to exports of certain staple home products. If the country's balance of payments still remains adverse more drastic steps may be taken to control trade by means of "quotas" and "licences". Under the "quota" system the government allows only a fixed quantity of certain articles to be imported in a fixed period of time. When the total has been reached, no more goods of that particular kind can be imported until the beginning of the next quota period. "Licensing" of imports also has the same effect. By issuing licences for imports (and exports) the government cannot only regulate the amount of commodities imported (and exported) but it can also regulate the amount coming from (and going to) different countries.

2. *Rationing the Supply of Exchange.* The state may (through the Central Bank) assume the exclusive right of buying and selling foreign exchange at fixed rates. These may be rates corresponding to the parities which existed at the time when exchange control was introduced, but they may be other rates. All open market dealings in bills, in this case, are done away with—the Central Bank being the only place where foreign exchange can be bought and sold and the official price being the only price at which payments can be made or received.<sup>1</sup>

3. *Exchange Equalization Fund.* It is created to enable the Central Bank to control exchange when the government has decided upon it. "Great

<sup>1</sup> Virtually it amounts to "exchange pegging" which has already been discussed.

Britain was the first country to set up such a fund. It began in June, 1932, with assets of about 150 million in Treasury bills, augmented in April 1933, by a further £ 200 million of Treasury bills, and in June, 1937, with yet a further £ 200 million, and it is still in existence. Its main object....was to affect purely speculative movements in sterling exchange rates whilst allowing "real" causes to affect the long-term trend. The Fund was to smooth out temporary fluctuations."<sup>1</sup> The assets of the fund consist of sterling (in the form of Treasury bills) and gold. The power of the Central Bank to keep sterling down is limited by the extent of its sterling assets, and its power to keep sterling up is limited by the extent of its foreign assets.

Some other countries, notably France and the United States have also established similar funds.

4. *Money Rates—The Bank Rate.* We have already seen that the exchange rates are affected by the rate for money *i. e.* the rates of interest. When interest rates at any important centre tend to rise, exchange rates on that point tend also to rise by reason of the natural desire to send money to any market where a greater return can be had for its use. Conversely, when interest rates go down, exchange rates on that point are lowered through the withdrawal of loanable capital which inevitably takes place. Hence, exchange can be effectively controlled by controlling the rates for money. Money rates can be controlled by regulating the Bank Rate *i. e.* the rate at which bills can be rediscounted at the Central Bank, because no bank will discount a bill for a customer at a rate very much lower than the official rate which it knows it will itself have to pay at the Central Bank in case

<sup>1</sup> Benham—*Economics*—p. 440.

re-discounting of the bill becomes advisable or necessary.

5. *Blocked Accounts.* The government may take steps to forbid the transfer out of the country of any sums in the home currency owned by foreigners. Such balances are then described as "frozen." The foreigners who own them are not allowed to draw upon them or are allowed to do so only to a limited extent and for a specified purpose such as to cover their personal expenditure while travelling in that country. Hence they are prevented not only from converting them into a foreign currency but even from utilizing them freely for purchasing goods and paying debts within the country.

6. *Clearing Agreements.* They are insisted upon, in the interest of their nationals, by countries exporting to a country practising exchange control. The countries controlling exchange have to guarantee, before export to them is permitted, that prompt payment will be made for all articles delivered to them.

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## SUMMARY

**Definition of the Rate of Exchange.** *It may be defined as the price of one unit of the currency of one country expressed in the money of the other.*

**Methods of Determining Rates of Exchange.** Since different countries of the world have different monetary standards, the rates of exchange between them are determined by different methods. In the case of countries on the gold standard the rate of exchange is determined by the Mint Par Theory, that is, by equating the metallic contents of their respective standard coins. The rate of exchange between England on one side and U. S. A., France and Germany etc., on the other, before the last War, was determined by this method. Notwithstanding



full freedom to send gold to and fro, daily transactions between such countries are normally conducted through bills of exchange. The price of these bills is determined by their demand and supply but cannot rise above or fall below the par by more than the cost of remitting an equivalent amount of bullion from one country to the other. There are two points, therefore, within which the prices of exchange bills fluctuate—the Upper Specie Point which is calculated by adding the cost of shipment and insurance to the mint par and the Lower Specie Point which is obtained by subtracting the cost of freight and insurance from the par.

The rate of exchange between one country on the gold standard and the other on an inconvertible paper currency standard depends *entirely* on the supply and demand of bills of exchange because, in the absence of the facility of importing and exporting gold, there is no help for the debtors but to discharge their obligations through exchange bills even though they may have to pay more for them. The same rule applies to all countries on an inconvertible paper currency standard. Hence, it is obvious that if the freedom to import and export gold freely does not exist, the rate of exchange is determined by the supply and demand of the bills of exchange and because these bills are drawn in response to trade requirements, the rate of exchange may be said to be determined by the balance of trade. This is the so-called Balance of Trade Theory which states that the exchange will be favourable to a country which exports more than what it imports and against a country whose imports exceed its exports. The words “exports” and “imports” are used in the widest sense to embrace all visible as well as invisible items and include, among recorded items, all those goods and services which are not recorded but which establish the claim of one country over the currency of the other *viz.*, earnings of the nationals of one country serving abroad in so far as they are remitted to the mother country, subscriptions for charitable purposes, expenditure of a nation's Government abroad, tributes and indemnities and the expenses of students and tourists residing or travelling abroad. A specimen of the Balance of Trade of India including visible items only is given and a table from a League of Nations' publication is reproduced to give an idea of the relative importance of some of the unrecorded items during the last five years.

**Exports Pay for Imports.** This is an important theory of international trade. It means that all the exports of a country (including invisible items) going to all the countries of the

world tend, in the long run, to be equal to its aggregate imports (including invisible imports) coming from all the countries with whom it deals. Normally, exchange of goods for goods and services takes place and the balance is adjusted through the remittance of specie which also influences the price levels and leads to the equation of imports and exports. It should, however, be remembered that the balance of trade is never settled within any period of twelve months like that of the official year but, if longer periods are taken, the adjustment will be seen to have taken place.

**The Purchasing Power Parity Theory.** It has been noticed that the rate of exchange between two countries on inconvertible paper currency standard is determined by the balance of trade. There is an alternative explanation which was offered by Gustav Cassel during the last War. According to it, the rate of exchange between two countries is determined by comparing their purchasing powers measured in terms of prices. If the prices of a country are higher than those of the other, the currency of the former will command more goods and services than the latter and the people of that country will demand more units of the other country's currency in exchange for their own. The exchange will, therefore, be favourable to the first country and unfavourable to the other. Hence, if fluctuations in prices have taken place, the new rate of exchange may be found out by multiplying the old rate by the quotient of the degree of inflation of the two currencies. This explanation is very convincing but, in actual practice, the rate of exchange calculated by means of the purchasing power parity theory frequently deviates from the existing rate of exchange. This is accounted for by the fact that index numbers are merely averages and that the selection of a wrong basic year or inclusion of wrong articles may give a different picture of the purchasing power of a currency altogether. Moreover, violent movements of exchange rates may prevent goods from finding their true level of prices or the speculators in exchange may exert their influence in fixing a rate different from the one calculated on the basis of index numbers of prices. The theory also ignores the effect of changes in the balance of trade which, as we have seen, are very important in determining the course of exchange from time to time.

For the purpose of fixing the rate of exchange, India falls in a different category altogether. It has got a token coin as standard coin whose value in terms of sterling was arbitrarily fixed at Re. 1 = 16d before the last War and Re. 1 = 18d since

1926-27. With the object of regulating exchange within the specie points the Government used to sell its own bills—called the Council and Reverse Council Bills—at approximately fixed prices. These bills also constituted an important means of remitting Home Charges, that is, the expenses of the Secretary of State incurred on behalf of the Government of India in England. The system of Council Bills has now been replaced by the system of purchase of sterling. Whenever the balance of trade is favourable to India and the rupee-sterling exchange threatens to rise above the upper specie point, the Government of India prevails upon the Exchange Banks to put their sterling resources in London at its disposal in exchange for money paid to them in India. The new system permits the Government to stabilize exchange more effectively than before. It helps the Government of India to remit money to the Secretary of State and also the Foreign Exchange Banks to draw money from England whenever their funds in India run short.

**Main Factors Affecting Exchange.** In the short period the rate of exchange is influenced by commercial and financial factors, *i. e.* by the balance of trade, the rates of interest (including the Bank Rate) prevailing in different centres and arbitrage dealings. In the long period the state of currency and credit as well as the political and industrial conditions of the country play an important part in the determination of exchange.

**Exchange Control.** As the stability of exchange is necessary for the trade and industries of the country as well as for the purpose of preserving the integrity of gold reserves, it is often desirable to prevent undue fluctuations of exchange by artificial means. Exchange is controlled partly by limiting imports (through quotas and licences) and stimulating exports (through bounties and subsidies) and partly by centralising all exchange dealings in the hands of the Central Bank. The Central Bank usually relies on its Bank Rate but the effectiveness of its operations depend upon the adequacy of the Exchange Equalisation Fund which is often instituted to correct temporary fluctuations of exchange. Exchange may also be controlled by “freezing” the accounts of the foreigners and by entering into Clearing Agreements.

## QUESTIONS

1. What is the rate of exchange? Indicate the causes of fluctuation in the rate of exchange. Is there any limit to these fluctuations? If so, are they rigidly fixed?

[Delhi Inter. 1928]

2. How is the Mint Par determined between England and U. S. A.? Show how the rate of exchange would be affected by (a) a loan contracted by England in U. S. A., (b) a relative rise in the rate of interest in London, (c) the outbreak of commercial crisis in New York.

[Punjab B. A., 1923]

3. How is the "bullion" or "melting" point determined in the case of the rupee?

[Delhi Inter. 1932]

4. On what do the gold points depend? Can exchange go beyond the gold points? If so, when and how?

[Punjab B. A. 1932]

5. Explain clearly what is meant by invisible exports and imports. Why is it not easy to gauge aright the exact amount and value of these invisible exports and imports at any particular moment?

[Delhi B. A. 1931 and 1933]

6. What do you understand by the term 'balance of trade'? Explain the factors which bring about the equation of indebtedness between India and other foreign countries of the world.

[Agra B. A. 1933]

7. In what sense it is true that imports must in the long run pay for exports.

[Calcutta B. A. 1931 and Delhi Inter. 1930]

8. What do you understand by purchasing power parity? Examine the usefulness of this conception.

[Delhi Inter. 1933 and Delhi B. A. 1934]

9. How far has Cassel's theory of foreign exchanges been seriously challenged? How would you account for the deviation of the exchanges from the par?

[Delhi B. A. (Hons.) 1932]

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10. Explain how exchange between two nations is normally maintained? Use the Indian monetary system as your chief illustration.

[Delhi Int. 1932]

11. Describe and explain the ways which the Government of India follows for the purpose of making remittances to the London Treasury.

[Delhi Int. 1931 and Delhi B. A. (Hons.) 1931]

12. Write brief explanatory notes on :

- (i) Home Charges.
- (ii) Specie Points.
- (iii) Council Bills.
- (iv) Unfavourable, Balance of Trade.
- (v) Invisible Exports.
- (vi) Mint Par of Exchange.
- (vii) Purchase of Sterling.

## CHAPTER IX

### MONETARY STANDARDS

From what has been said against the dangers of inflation, it should be quite clear that, in the interest of social justice and harmony, the value of money measured in terms of commodities should be kept stable. The prices are kept stationary by adopting a suitable coin or combination of coins as standards of value in such a way as to keep the supply of currency properly adjusted to its demand, although it cannot be denied that an ideal standard which will not inflict any injury on any individual is unattainable in practice.

**Bi-metallism and Mono-metallism Defined.** A monetary system in which the principal or standard money is composed of coins of two different metals (say, gold *and* silver) is called Bi-metallism or Double Standard. A system in which the standard or principal coin is made of one metal (gold *or* silver) is called Mono-metallism.

**Bi-metallism or Double Standard.** In a true bi-metallic standard, both the standard coins are freely minted, are unlimited legal tender and there is a fixed ratio of exchange between them. For instance, if in U. S. A. a silver dollar contains 16 grains of silver for every grain of gold in a gold dollar, the ratio of conversion between the two standard coins would be 16 to 1. A debtor would have the option, unless otherwise bound by his contract, of making payment either in gold or in silver money. This system has been advocated on the ground that two moneys in circulation

provide a sort of *compensatory*<sup>1</sup> influence over each other which is very favourable for the maintenance of steady prices. For example, an increase or decrease in the production of one metal will often be counteracted by a probable decrease or increase in the production of another metal with the result that the value of money, on the whole, would be steadier under bi-metallism than under mono-metallism. Similarly, the overvalued metal will tend to drive the undervalued metal out of circulation. It alone will be presented at the mint for coinage. Its withdrawal from the bullion market will tend to raise its value there. On the other hand, the under-valued metal not being presented at the mint for coinage, will increase in supply in the market and this will tend to reduce its value. In this way the market ratio will always revert to the legal ratio whenever any divergence between the two takes place. It has also been suggested that, owing to the circulation of two standard coins, the total money stock is greater and the resulting high prices more favourable for the

1 Jevons calls it 'equilibratory action' which he explains as follows :—

"If silver becomes more valuable .... compared with gold, there arises at once a tendency to import gold into any country possessing the double standard so that it may be coined there and exchanged for a legally equivalent weight of silver coin to be exported again.. .... if gold rose in value compared with silver the action would be reversed; gold would be absorbed and silver liberated. At any moment the standard of value is doubtless one metal or the other, and not both; yet the fact that there is an alternation tends to make each vary much less than it would otherwise do. It cannot prevent both metals from falling or rising in value compared with other commodities, but it can throw variations of supply and demand over a larger area instead of having each metal to be affected merely by its own accidents."

"Imagine two reservoirs of water, each subject to independent variations of supply and demand. In the absence of any connecting pipe, the level of water in each will be subject to its own fluctuations only. But if we open a connection, the water in both will assume a certain mean level and the effects of any excessive supply or demand will be distributed over the whole area of both reservoirs"—*Money and the Mechanism of Exchange*—pp. 130-140.

stimulation of trade and industry. Higher prices are also supposed to be beneficial to the poor debtors of a country who, according to some, deserve greater consideration than the creditors. But, by far the most important advantage urged in favour of bi-metallism is that it helps the trade of a country both with gold and silver using countries.

Bi-metallism was adopted by Europe and America in the eighteenth century but it was subsequently given up owing to the wastage of precious metals and owing to the fact that the depreciated coin often manages to drive the dearer one out of circulation. This tendency of the cheaper money to drive the dearer one out of circulation (which is now called Gresham's Law) seems to have been recognised even among the ancient Greeks and needs to be studied carefully.

**Gresham's Law.** When different coins are in circulation, all of them are not alike. Some are made of silver, others are made of gold. Some are fresh from the mint, others contain more metal than those which have been worn out by constant use. The good coins are apparently more valuable for making payments abroad and for industrial purposes and therefore the people, *so far as they can help it*, keep them in the secure corners of their pockets and transact normal business with the help of comparatively worse coins. "The reason why the cheaper of two moneys always prevails is that the choice of the use of money rests chiefly with the man who gives it in exchange, not with the man who receives it. When any one has the choice of paying his debts in either of two moneys, motives of economy will prompt him to use the cheaper."<sup>1</sup> The same thing happens when metallic and paper currencies

<sup>1</sup> Fisher—*The Purchasing Power of the Money*—p. 113.



are in circulation side by side. The paper note, being the worse of the two, remains in active circulation while the metallic coins remain concealed, until they are taken out of the hoards for emergent purposes. This tendency of the bad money of driving good money out of circulation is called Gresham's Law—after Sir Thomas Gresham who called attention to this phenomenon more sharply than any body up to his time had done. The phrase “so far as they can help it” is particularly significant for good and bad money will *both* remain in circulation so long as the good and the bad money taken together are not in excess of the monetary needs of the community. Again, an inferior money will not circulate in opposition to custom or public opinion. An inconvertible note, for example, or an old coin, will *itself* be driven out of circulation if the public refuses to accept it in preference to some better form of currency. “We have a striking illustration of the influence of custom in the history of California during the Civil War. The people of California would not use the greenbacks issued by the Government and continued to use gold whilst the rest of the United States was using paper money.”<sup>1</sup> The law, thus, is a mere statement of a tendency and must be stated hypothetically. Kinley has put it thus: “If more than one form of money is legally usable in a country, and if one of these is more valuable for some other use than it is for making exchanges, then the inferior portion of the currency will supplant the superior to the extent that the two portions together exceed the need for currency in the country, provided that public opinion or any other economic force does not interfere with the operation of the self-interest of dealers in money.”<sup>2</sup>

<sup>1</sup> *Wadia and Joshi—op. cit.* pp. 115-116.

<sup>2</sup> *Money*—pp. 57-58.

Now, since gold and silver are subject to different conditions, it is difficult to maintain a fixed ratio between them. If there are permanent forces causing permanent differences in the prices of gold and silver the old ratio will not be restored. The under-valued metal will gradually go out of circulation and the metallic money will consist of the overvalued money only. Consequently, all bi-metallic countries are really left with *one* kind of money and that too a bad one. The compensatory action of the double standard presupposes an international agreement for the adoption of bi-metallism. There may be forces at work which, instead of correcting the discrepancies between the market and legal ratios, may accentuate the discrepancies.

**International Bi-metallism.** In order to guard against the operation of Gresham's Law and to maintain a fixed ratio between gold and silver coins, bi-metallism on an international basis has been suggested. The scheme would certainly be more effective but there seems to be no prospect of such an international agreement for a very long time to come.

**Limping Bi-metallism.** It is an imperfect form of bi-metallism. Under a "Limping" standard, two metals are unlimited legal tender but only *one* has got free coinage. Such a system comes about when, in a system of bi-metallism, before either metal can wholly expel the other, the mint is closed to the cheaper of them. It existed in France and U.S.A. before the last war when gold and silver coins were both unlimited legal tender but only gold coins had a free coinage.

**Parallel Standard.** Whenever it is thought desirable to keep gold and silver coins permanently in circulation side by side, the fixing of the value

of one coin in terms of the other is left to the open market and the Treasury is allowed to accept them at the rate of exchange of the day. This system which was introduced in England in 1663 is called the "parallel standard" or "alternative standard." It was found unsatisfactory because traders found it very inconvenient to have to calculate continually in different coins of money which stood to each other in a fluctuating ratio.

**Mono-metallism.** It may exist either as gold standard or as silver standard. Silver being a cheap metal and more open to changes in price is only adopted by comparatively poor and uncivilised countries like China. The more progressive countries, with larger scales of incomes and transactions, use gold as the principal medium of exchange. The price of the yellow metal generally remains very steady and the countries adopting it enjoy greater stability of purchasing power than countries on the silver standard.<sup>1</sup>

**The Gold Standard.** In modern times, the monetary standard upon which the leading nations of the world have pinned their faith is that of gold. For centuries gold has stood, rightly or wrongly, as a symbol of solid, substantial wealth and has been a serviceable standard of value. At all times, and amongst people at every stage of economic development, gold has been held in high esteem, partly on account of its *scarcity* and partly on account of its *attractive appearance* and utility. The gold standard was originally adopted by few important countries but was soon followed by the rest for the simple reason that the adoption of the gold standard brought the nation adopting it into relations of stable exchange with the richer nations, and pre-eminently with England. Every addition to the list of gold standard countries increased the

1 Al-o read Hawtrey—*Monetary Reconstruction*—p. 50.

stability of gold by spreading over a wider field possible, fluctuations in its exchange value arising from changes in the total supply or in the demand in any one country.<sup>1</sup> Hence, it greatly facilitates international division of labour and international investment. Mr. Keynes, an eminent economist, was so enthusiastic about the efficacy of the gold standard that in the Reconstruction Number of the Manchester Guardian just after the War he wrote: "If gold standard could be reintroduced throughout Europe, we all agree that this would promote, as nothing else can, the revival not only of trade and of production but of international credit and the movement of capital to where it is needed most."<sup>2</sup> The recent abnormal rise of prices has led some people to suggest that gold standard has no special advantages and that the same results may be obtained by a silver standard or a well-regulated paper standard. In fact they say that the gold standard was invented by great financiers in order to enrich themselves and to get the world in their power. They invented the gold standard in order to obtain the position to manipulate slumps and booms and should be opposed by the masses who stand to lose by instability of prices and exchange.<sup>3</sup> But the

1 See Conant—*Principles of Money and Banking*—Vol. I, p. 319.

2 Section I, pp. 3-4.

3 "When prices of ordinary commodities rise to their heights which causes the value of gold to depreciate in terms of commodities these financiers sell property and commodities heavily in order to restore the value of their gold and invest the proceeds from their sales of commodities and property in further purchases of gold, because they know that the prices in general will fall further owing to the impetus. Their sales of commodities and property encourages or compels every one else to sell and this intensifies the slumps. When prices in general have fallen to the lowest limit possible and the value of gold in terms of commodities has reached its maximum, they sell much of their gold and begin buying property and commodities, and this causes every one with any money or credit left after the slump, to follow suit. This is the cause of the booms." Major Vanrenen, a big Zamindar of the Punjab, at a meeting held under the auspices of the Punjab Branch of the Currency League of India on 3rd. November 1933.

preference for gold as the one commodity that can adequately fulfil the requirements of money cannot be dismissed as merely sentimental. It is based upon an instinctive appreciation of its economic potentialities and on an adequate analysis of its economic virtues by the civilised and thinking sections of the humanity. It provides for automatic expansion and contraction of currency. More coins can be created at will and if there is a superfluity of coins, it can be removed by melting them down. Owing to the fact that there is a free and open market for gold, its outward and inward flow is checked. Fluctuations in the rates of exchange are confined to specie points and loss to trade on account of instability of exchange is greatly minimised. Moreover, the fact that a gold standard acts as an effective check on any attempt on the part of Government to manufacture currency should not be lightly brushed aside.

**Kinds of Gold Standard.** A gold standard (or as a matter of that, a silver standard) is generally of two types,<sup>1</sup> viz:

1. Gold Currency Standard; and
2. Gold Bullion Standard.

**Gold Currency Standard.** The pre-War economists attached too much importance to the circulation of gold coins without which they thought the stability of currency and prices could not be

1 Some writers have referred to all monetary standards having the remotest relation to gold as gold standard even though some of them lack the essential requisites of a true gold standard. L. L. B. Angas, for example, in "*The Problems of the Foreign Exchanges*" has, in addition to the two forms of gold standard described in this section, pointed out five more types viz. Gold Exchange Standard, Variable Gold Standard, Rationed Gold Standard, "Controlled Sterling Loan" type of Gold Standard and the Authentic Gold Standard. See. pp. 39-49.

maintained. The Great War, however, emphasised the necessity of economising the use of precious metals. People realised that gold was, after all, not an end in itself but a mere means to an end. It was wanted in circulation not for its own sake but because its presence inspired full public confidence in the currency policy of the Government and because people in foreign countries did not hesitate to accept it in payment of dues owing to them.<sup>1</sup> So they said that a gold standard need not be regarded as absolutely identical with gold currency. Even Mr. Keynes, who was such a staunch advocate of gold standard stated: "I reject the policy of restoring the gold standard on *pre-war lines*.....I regard the stability of prices, credit and employment as of paramount importance and feel no confidence that an old-fashioned gold standard will even give us the modicum of stability that it used to give."<sup>2</sup> According to him (and other eminent economists) any system which secures *full and free convertibility of note-issue into gold in any form or shape, at all times and for all purposes*, can be called a gold standard.<sup>3</sup> Such a scheme would work only if

1 See Gregory's article in *Economica*, June 1934, p. 170.

2 *A Tract on Monetary Reform*, pp. 163-176.

3 Keynes has defined a gold standard as "in its essence an abstract standard where the price of gold has been fixed not absolutely but so far that variations of the price are restricted within very narrow limits," or what amounts to the same thing, "where the unit of currency has an approximately fixed gold value."

Heilperin likewise maintains that gold-standard currency is *not* gold currency but paper money administered in such a way as to keep the price of gold stable.

In his *International Monetary Economics* published in 1939 he has drawn a distinction between a country being on the gold standard and its having a monetary system linked to gold. The former term is used to designate the traditional notion of the gold standard as a system under which the price of gold is fixed by the monetary laws of the country while the latter is used to describe a situation where currency is linked to gold in a less determined way. See pages 176-177.

there is a free gold market effectively controlled by a proper banking system.

**The Gold Bullion Standard.** An experiment was tried on these lines for the first time in England in 1925 when the note-issue, instead of being convertible into sovereigns and half-sovereigns, was made convertible into gold *bars* containing 400 ounces of fine gold at the rate of £ 3. 17s. 10<sup>1</sup>/<sub>2</sub>d. per standard ounce. The system was called the Gold Bullion Standard. In 1928, the French introduced a variation of this new system when the Bank of France was given the option of redeeming notes either in gold bars or in gold coins. As we shall see presently, a system similar to this was also recommended by the Hilton Young Commission for India in 1926.

In this type of gold standard, although gold is *theoretically* the standard of value, there is little or no gold in circulation. The normal monetary circulation consists largely of token money (paper and silver) which is legally convertible into gold bars or bullion whether the gold is required for internal purposes or for export. Such a system is certainly much more *scientific* but one cannot be too sure of its successful working in practice.<sup>1</sup>

**The Gold Exchange Standard.** It may also happen that, out of considerations of economy or for the purpose of maintaining a stable par of exchange, a country may have an inferior metal for local purposes and make gold (the international money) available for *foreign payments only* at an *approximately fixed rate*. Such a system is called a Gold Exchange Standard. It existed in India

<sup>1</sup> Also see Chapter XII.

before the War and for some years after the Armistice but has been abandoned since. The Government of India, before 1917, used to give one pound for every 15 rupees tendered to them in India to enable Indian importers to pay for their goods in sterling in England and, conversely, when foreign debtors wished to square up their debts in India, they had the option of delivering a pound sterling in England to get 15 rupees in India. The popularity of the Gold Exchange Standard is based upon the assumption that foreign exchange is as good as gold as cover for the national currency. The advantages claimed in favour of the Gold Exchange Standard have been nicely summed up by Conant as follows :—

1. It decreases the pressure upon the world supply of gold ;
2. It helps the maintenance of a stable par of exchange between Oriental and Western countries ;
3. It is admirably suited to poor and undeveloped countries ; and
4. It opens the market for silver and thus helps in steadying its value.<sup>1</sup>

It should, however, be remembered that the movement of foreign exchange from one country to another has by no means the same reaction on their price structures as the movement of gold. Under a gold standard, when gold leaves one country the prices fall whilst that of the receiving country expand to a like extent. In the case of the gold exchange standard, when the Central Bank purchases foreign exchange it increases the amount

1 *Principles of Money and Banking*—Vol. i, pp. 392-403.

Also read Heilperin—*International Monetary Economics*—pp. 215-218.



of its note-issue but at the same time there is no shrinkage in the credit structure of the country from which the foreign exchange is obtained. To put it more simply, because the gold does not go in and out, prices cannot easily be brought to an equality in all countries and fluctuations in exchange continue. Moreover, a gold exchange standard requires, for its successful working, a strong machinery for the purpose of maintaining an approximately fixed ratio of exchange between the internal currency and gold and sufficient reserves to back it up.

**Sterling or Dollar Exchange Standard.** If, however, instead of making the token currency convertible into gold, a country links it to sterling or dollar (or an independent currency of any other major country) the monetary system will be known after the name of the particular currency to which it is linked. Because the external value of the rupee is now-a-days fixed in terms of the sterling, the present Indian currency system is called the Sterling Exchange Standard. It would be called the Dollar Exchange Standard if the exchange value of the rupee is fixed in terms of the dollar and not in terms of English currency. Like the Gold Exchange Standard, even this system depends for its proper working upon the type of the fund of exchange (reserves) and the form in which the fund is kept. It is generally unpopular because it is wrong in principle to link the destinies of the currency and prices of one country to the *fluctuating destinies* of any other currency however firmly linked to gold it may be. The following table shows very wide changes in the value of sterling in respect of dollar (gold) in recent years. It stands to reason that India, whose currency is linked to that of England, must have suffered accordingly. The dates have been taken at random.

Date.	Sterling—Dollar Exchange. (Normal Par=£1=\$ 4.866)
April, 1931.	4.851
September, 24, 1931.	3.82
March, 10, 1932.	3.63
August, 10, 1932.	3.48
December, 1, 1932.	3.19
January, 1933.	3.15
June, 1933.	4.11
November, 24, 1933.	5.20
December, 14, 1933.	5.01
August, 17, 1934.	5.093
December, 21, 1934.	4.915
May, 10, 1935.	4.852

**Paper Currency Standard.** The metallic standards are possible only when plenty of gold (or silver) is available but when the world is faced with a 'gold famine,' as at present, the note-issue ceases to be legally convertible into precious metals. A system of paper money is usually the result of exceptional circumstances in which notes are no longer convertible and are granted *forced currency*. During the War, for example, gold was rare and was locked up by the creditor nations like America and the leading countries of Europe depended upon the printing press for providing them with the necessary 'sinews of war'. In September 1931, England abandoned the gold standard and still continues to be on an inconvertible paper currency standard. Needless to say that the example of England has already been followed by several countries of Europe.

A currency system based on mere paper is generally very unpopular and would not be tolerated except in times of extreme national emergencies. "An inconvertible paper is viewed with uneasiness. People fear, and not without reason, that it will be issued in excess. Governments

which have recourse to it are strongly tempted to escape the unpopularity of taxing the people openly by taxing them indirectly through the emission of more notes.' It is so easy to get from a printing press any extra resources that are wanted urgently. As more inconvertible paper is put out, beyond a certain amount, it depreciates and as it depreciates public confidence in the currency is shaken and it depreciates still more."<sup>1</sup> The debtors gain at the expense of the creditors and the people earning fixed incomes sustain un-merited losses.<sup>2</sup> "A government should, indeed, be in a desperate position which ventures thus to break all social contracts and relations which it was created to preserve."<sup>3</sup>

Another argument usually advanced against the paper standard is that, by causing uncertainty of prices, it checks internal and external business. It is also a favourite sport of currency speculators and a potent cause of dumping. Yet another essential characteristic of the paper standard is that the currency *circulates internally* and, therefore, the system does not provide a monetary basis in common with other national monetary systems. "Almost all monetary phenomena which require elucidation and almost all the problems which need solution in countries on a paper currency will be seen to derive from this essential characteristic."<sup>4</sup>

Some enthusiasts of the paper standard, however, are of opinion that the defects of paper as standard of value have been grossly exaggerated. Prices in paper standard countries, they say, are by no means unstable or less stable than prices in gold

1 Chapman—*Outlines of Political Economy*, p. 245.

2 Revise Chapter VI—*Inflation and its effects*.

3 Jevons—*Money and the Mechanism of Exchange*, p. 236.

4 Bertrand Nagaro—*Modern Monetary Systems*, p. 9.

standard countries for gold prices have frequently moved upwards and downwards by over 20 per cent during the last few years. Regarding the argument that inconvertible paper allows spendthrift governments to print more money, they point out that "if an irresponsible and reckless government does ever happen to get into power and run into debt, it never hesitates, even under the gold standard, to abandon gold and print paper money. History supplies a long series of instances where even gold has not been an effective check at all."<sup>1</sup> Moreover, far from creating general instability, they say, exchange can be regulated more *effectively* and *automatically* under a paper standard than under any form of gold standard. "The beauty of the paper system," says Angas, "is that, as soon as any dis-equilibrium between demand and supply occurs, a sharp fluctuation in the price of foreign exchange *immediately* takes place, which, by its immediate action on both exports and imports, rapidly restores equilibrium. The laws of supply and demand and price are thus allowed to operate freely and quickly—as theoretically they should in any market like that for foreign exchange, which is subjected to violent *short-run fluctuations in both demand and supply*."<sup>2</sup> This argument may be valid if applied to a (theoretically perfect) international paper standard but certainly does not hold good in the case of those nations some of whom are on paper and others on gold standard for, as has already been pointed out, the fluctuations of exchange under the gold standard are *too small* to make any *appreciable* difference in the exports and imports. The exponents of the paper standard in minimising the dangers of inflation and artificial management for

1 Angas—*The Problems of the Foreign Exchange*, p. 155.

2 *Ibid* p. 62.

political purposes have obviously rested their case on the imperfections of the gold standard or on its mis-management. It will, however, be admitted that ordinarily a gold standard is far superior to any paper standard managed in the usual way and that an ill-managed paper standard inflicts heavier losses on the people than can be conceived of under any form of gold standard.<sup>1</sup>

**Essentials of a Good Monetary System.** From what has been said above it would appear that the selection of a monetary standard should neither be *arbitrary* nor *sentimental*. Although the system of each country will depend upon its own social and economic requirements, an ideal standard should satisfy the following conditions :—

1. It should stabilize currency, prices and exchange both within the country and outside;
2. It should economise the use of precious metals;
3. It should be elastic, that is, capable of expansion and contraction in response to the requirements of trade; and
4. It should command the confidence of the people.<sup>2</sup>

### SUMMARY

The stability of currency and prices in a country can be secured by adopting a suitable coin or combination of coins as standard of value. If two standard coins circulate side by side the monetary system is called bi-metallism but if the

1 "Fiat paper has been well called the alcohol of commerce whose fumes entering the brains of individuals and of government officers, seem to make them incapable of sober judgment or self-restraint in the matter of further issue and further demoralisation takes place." Kinley—*Money*, p. 351.

2 "The main need of the world today.....is more confidence. There can be no surer route to the re-establishment of confidence than the stabilisation of exchanges." L. Robbins—"Paper Systems," an article in the *Gold* (Times Publishing Co :) p. 46.

values of all other coins are adjusted in terms of one standard coin it is called mono-metallism.

➤ **Bi-metallism and Gresham's Law.** Under bi-metallism both the standard coins are freely minted and are unlimited legal tender and the value of one in terms of the other is rigidly fixed. This system is advocated on the ground that changes in the value of either currency are automatically set right by a sort of a compensatory action between them and because it helps in maintaining a stable par of exchange both with gold and silver using countries. It also keeps prices up and thus helps production. But the system does not work well owing to the operation of Gresham's Law according to which the cheap currency drives the dear one out of circulation. This law applies to all kinds of money and in each case the bad money tends to drive the good one out of circulation except when the supply of money is less than, or just equal to, the demand or when the public opinion is opposed to the acceptance of bad coins. In the case of bi-metallism, silver, a cheap metal, throws gold very much into the back-ground.

**Limping Bi-metallism.** It is an imperfect form of bi-metallism under which two metals are unlimited legal tender but only one (the dearer one) has got free coinage. It comes into existence when there is danger of the cheap metal expelling the dear one out of circulation.

**Parallel Standard.** In it there are two standard coins in circulation but the value between them is not fixed. They circulate at their bullion value from day to day. It was introduced in England in 1663 but was given up as being obviously inconvenient and speculative.

**Mono-metallism.** It may exist in the form of gold or silver standard—the latter being more suitable to poor and less civilised countries.

**The Gold Standard.** It has always been popular with the people owing to the utility and intrinsic merits of gold and because countries adopting it can hope to enter into relations of stable exchange with the richer countries, especially England. Before the war, the gold standard was regarded as absolutely identical with the gold currency standard but now the economists do not attach any great importance to the circulation of gold coins. According to the post-war conceptions, therefore, a gold standard can exist even if the token currency is made legally convertible into

a gold bar of fixed weight and fineness at all times and for all purposes. This latest modification of the gold standard is called the Gold Bullion Standard. It is supposed to be as effective in its working as the gold currency standard and has the additional advantage of economising the use of precious metals. People have, however, expressed grave doubts about its successful working.

**The Gold Exchange Standard.** Under it there are two currencies—a token currency for internal purposes and an external currency for foreign payments only and the value of one in terms of the other (for foreign transactions only) is approximately fixed. The system permits economy in the use of gold and is particularly suited to poor and undeveloped countries but is not viewed with favour partly because it makes the currency of one country dependent upon the currency of another and partly because it does not influence the price levels. It also requires an elaborate machinery for regulating exchange and rich specie reserves.

**Sterling or Dollar Exchange Standard.** If the currency of one country is linked to the currency of another the monetary standard is known after their respective standard money. For example, the Indian system would be called the Rupee-Sterling or Rupee-Dollar Exchange standard according as it is linked to the currency of England or U.S.A. respectively. Such a system is generally harmful because it makes the currency and prices of one country dependent upon the fate of the currency system of the other however firmly linked to gold the latter may be.

**Inconvertible Paper Currency Standard.** It is introduced in extreme national emergencies like big wars when the government cannot afford to manufacture metallic money. It should not be adopted for a single day more than it is required because there is a grave apprehension of over-issue and consequent depreciation of currency with its attendant evils.

### **Essentials of a Good Monetary System.**

1. It should stabilise currency, prices and exchange.
  2. It should economise the use of gold.
  3. It should be elastic.
  4. It should inspire public confidence.
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## QUESTIONS

1. Explain what is meant by 'monetary standards'. By what name is the monetary standard obtaining in India called and why? Show how it functions. [U.P. Inter. 1934]

2. What is bi-metallism? Describe its chief advantages and disadvantages. [Calcutta B.A. 1925]

3. Indicate the characteristics of bi-metallism and contrast it with a mono metallic standard on one side and a parallel standard on the other.

4. Comment on the statement—"Bad money drives good money out of circulation."

5. What are the essential characteristics of a gold standard? In what respects does the gold standard at the present time differ from that which existed in pre-War days?

6. To what extent does the existence of a gold standard guarantee the stability of prices?

7. "The gold standard is in its essence an abstract standard where the price of gold is fixed not absolutely but so far that variations of the price are restricted within very narrow limits." Explain this and bring out clearly the contrast between the Gold Exchange Standard and the Gold Bullion Standard. [Delhi B.A. 1932 ; Agra B.A. 1932]

8. In what different ways is it possible to combine gold and silver in the currency system of a country?

[Calcutta B.A. 1931]

9. Criticise the suggestion that the use of gold as a medium of exchange involves a corresponding loss of national wealth which might be saved by replacing the metal by tokens.

10. Write brief explanatory notes on :—

(a) Gresham's Law.

(b) Law of Compensatory Action.

(c) Sterling Exchange Standard.

(d) Limping Bi-metallism.

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# CHAPTER X

## THE INDIAN CURRENCY SYSTEM

### THE PRE-WAR PERIOD

We are now in a position to study the historical evolution of the Indian currency system a little more in detail and to discuss the position of the rupee in each period.

**Before 1835.**<sup>1</sup> A great variety of gold and silver coins circulated in different parts of the country—silver rupees being used chiefly as standard money while the value of gold coins usually depended upon the market price of gold. Much inconvenience was caused by the circulation of so many gold and silver coins<sup>2</sup> of different values and denominations with the result that, by the Act of 1835 (No. XVII), silver rupees of 180 grains  $\frac{11}{12}$ th fine (that is, containing 165 grains of pure silver and 15 grains of alloy) were made standard coins for the whole of the East India Company's Dominions in India. Gold coins were deprived of their legal tender qualification although gold mohurs of the same weight and fineness as the rupee continued to be minted in large amounts on Government account and circulated at their bullion value.

**1835-1873. The Silver Standard.** Thus was introduced a universal and an automatic silver standard. Mints were open to the free coinage of silver when offered in sums of not less than 1000

1 Those who desire to study the history of this period in detail will be well-advised to read Robert Chalmers'—*A History of Currency in the British Colonies*—pp. 336-348 and Sir Jadunath Sarkar's *Economics of British India* (4th Edn: 1917).

2 A Bengal regulation of 1793 mentions no less than 27 varieties of rupees as current in the several districts. Also read Macleod, *Indian Currency*, p. 13.

For a still more detailed account read J. C. Sinha—*Indian Currency Problems in the Last Decade*, pp. 3-7.

tolas. The coinage charges were 2 per cent for silver  $\frac{11}{12}$ th fine in addition to 1 per cent for melting. The new rupees were unlimited legal tender throughout the length and breadth of British India. The exchange value of the rupee depended on the fall or rise in the value of silver. No ratio between gold and silver was fixed. It alternated according to the variations in the prices of gold and silver. Attempts were made to introduce a gold currency standard especially after 1866 when the Mansfield Commission suggested the advisability of a legal tender of gold being made a part of the currency arrangements of India but they failed especially owing to a heavy decline in the gold price of silver, caused by its de-monetisation by Germany and the Latin Union,<sup>1</sup> and its over-production.

### 1873-1893. Break-down of the Silver Standard.

The price of silver started falling in 1873 and by 1893 had fallen by about 40 per cent.<sup>2</sup> The rate of exchange (with gold) fell from 20.5d in 1880 to 14.9d per rupee in 1893 as the following table will show :—

Year	Average price of silver per ounce (in pence)	Average rate of exchange (in pence per rupee)
Average of 5 years ending 1880	53	20.530
" " " " 1885	51	19.644
" " " " 1890	44	17.108
" " March 31, 1891	47	18.089
" " " " 1892	45	16.733
" " " " 1893	39	14.984

1 Comprising France, Belgium, Switzerland and Italy.

2 It will be interesting to note that although this period is characterised by fall of price, there was actually a rise between 1890 and 1892. The reason was that, under the provisions of the Sherman Silver Purchase Act of 1890, the United States were compelled to buy 4,500,000 ounces of silver every month in payment for which they issued "treasury notes." "These purchases for a time artificially buoyed up the price of silver, but the accumulation of silver was becoming dangerously large and the silver market was in a precarious condition because of the agitation for the repeal of this Act and the further danger that much of this accumulated silver might be upon the market."

This had obviously serious consequences. People purchased cheap silver and presented it to the mints for being coined into rupees. The amount of money in circulation increased accompanied by an inevitable increase in prices. The import trade suffered as well as those British officials who received salary in rupees but who remitted a part of it to England because they could now send only fewer sovereigns than before. It imposed *heavy financial burdens*<sup>1</sup> on the Government of India which had to remit more Indian money in payment of Home Charges. The wage-earners also suffered owing to rise of prices.

The Government tried various alternatives and ultimately referred the whole question to the Herschell Commission in 1893. The recommendations of this Commission were embodied in the Coinage Act of 1893. This act provided for the immediate closing of the Indian mints to the free coinage of silver with the proviso that the Indian Government should retain power to coin silver on their own account. Three administrative Notifications were also issued—the *first* provided for giving rupees in exchange for gold presented at the Indian Mints at the rate of 16d to the rupee; the *second* authorised the receipt of sovereigns and half-sovereigns by the Government in payment of taxes and other Government dues at the same

1 "To make this point clearer, it may be mentioned that in 1873-74, before the fall in the exchange value of the rupee commenced, the amount of Home remittance in lieu of payments the Secretary of State makes in England on behalf of the Indian Government, for such charges as interest on debt raised in England, civil and military pensions, salaries, the price of stores, etc., was about £13 millions which at a rate of exchange of 1s. 10.351d was represented by Rs. 14,26,57,000. During 1892-93 the amount remitted was £16½ millions which at the average rate of exchange in this year, viz., 1s. 2.985d, required payment of Rs. 26,47,84,150. If this had been remitted at the rate of exchange of the year 1873-74, it would have needed only Rs. 17,75,19,200; which means that there was a loss of Rs. 8,72,64,950 entailed upon India by the fall of exchange in that year." Kale—*Golkhate and Economic Reforms*—p. 28.

rate and the *third* provided for the issue of currency notes in exchange for British coin or gold bullion at the corresponding rate. "The objects were to arrest the fall in the exchange value of the rupee, to encourage the import of foreign capital, to familiarise the people with the use of gold sovereign and, finally, to discourage the imports of silver." The rate of 16d was chosen partly because it was in the neighbourhood of the average exchange rate of the previous two and a half years and partly because at this rate a sovereign would be the equivalent of fifteen rupees, the rate at which the gold mohur, which was demonetised in 1835, exchanged for rupee. The rupees, moreover, contain sixteen annas and one penny was thus the equivalent of one anna.

**1893-1898.** The change proved to be very beneficial. "Down to June, 1893—the month in which the mints were closed—the bullion value of the rupee and the exchange value moved continually together, but from that date forward the close parallelism in the movements of the two values ceased. It was no longer possible to have bullion transformed into rupees by the payment of a small brassage charge whenever the gold value of the rupee rose above the gold value of 180 grains of silver,  $\frac{11}{12}$ th fine." By thus controlling the minting of rupees and by giving it an arbitrary value the Government could control its quantity and value. The currency was starved and prices fell till in January, 1898 the rupee touched 1s. 4d.

The following table based on the statistics supplied by Mr. Atkinson, the then Accountant General of the United Provinces, gives an idea of the course of prices during the 13 years—1887-1899.

Year.	Index No. of Prices.	Year.	Index No. of Prices.	Year.	Index No. of Prices.
1887	101	1892	128	1897	149
1888	108	1893	125	1898	122
1889	114	1894	119	1899	127
1890	114	1895	116		
1891	116	1896	127		

It will be noticed that, whereas during the six years preceding the closing of the mints, prices rose from 101 to 121, they actually fell after 1893 except in 1896 and 1897 when, owing to a severe famine, the prices of food and grain rose much above expectations. The Government appointed another Committee, presided over by Sir Henry Fowler, in 1898 to review the changes brought about in the Indian currency system between 1893 and 1898 and to suggest "active measures to secure the stability of exchange which was the main object of the policy adopted in June 1893." The main recommendations of the Fowler Committee were that the sovereigns should be declared legal tender throughout British India at Rs. 15 per sovereign and that a gold standard with its natural accompaniment of gold currency should be established. The Committee also recommended that the Indian mints should continue to be closed to the unrestricted coinage of silver and should be opened to the unrestricted coinage of gold. Fresh rupees should not be coined until absolutely necessary and that any profit on the coinage of rupees should be kept in gold as a special reserve apart from the paper currency reserve. The new reserve, called the Gold Standard Reserve, was to be used for maintaining the exchange value of the rupee.

The Government of India accepted these recommendations. Sovereigns were declared legal tender, the Gold Standard Reserve was instituted

and arrangements were made for the coinage of gold in India.<sup>1</sup>

### 1898-1914. The Gold Exchange Standard.

The scheme of establishing a gold currency standard, however, did not succeed owing partly to our traditional associations with the rupee, partly to the operation of the Gresham's Law but mostly due to our transactions being of small value.<sup>2</sup> Moreover, the nine years' following the Fowler Committee were years of good harvests and all-round business prosperity. There was a great demand for money in circulation and people were anxious to purchase rupees (and currency notes) for gold which was incidentally depreciating in value all over the world chiefly as a result of large gold production in South Africa. The Government were, therefore, literally "swamped (temporarily) by gold" and gold coins were gradually driven away from circulation. The coinage of rupees had to be resumed in 1900 and a part of the Paper Currency Reserve was transferred, temporarily in 1898 and permanently in 1902, to London for the purchase of silver required for minting fresh rupees. The Government at last withdrew its offer to convert token currency into gold for internal purposes. It merely undertook to exchange rupees for sovereigns for *external purposes only*. The plan worked like this. Whenever the balance of trade was favourable and the British importers wished to remit money to India, the Secretary of State accepted the payment (at rates representing India's gold import point *viz.* rs. 4½ d and issued a writ (Council Bill) requesting the Government of India to pay the equivalent in

1 The scheme was, however, dropped when nearly complete in 1902.

2 Some people have also ascribed it to the opposition of the British Treasury. See *Industry Year Book and Directory*, 1933, page 82.

3 Except 1907-8 when a disastrous famine and plague overtook the country.

Indian currency out of the Paper Currency Reserve. The receipt in England went to strengthen the Paper Currency Reserve in England while the same amount of currency was added to circulation in India. For sometime this expedient was adopted only when the Secretary of State wanted to get money in respect of Home Charges, but in 1904 the Secretary of State announced his willingness to sell Council Bills in unlimited amounts at the rate of 1s. 4 $\frac{1}{8}$  d. The practice was continued upto 1907 when India was again visited by a disastrous famine. The balance of trade became unfavourable and the exchange tended to go below the gold export point (1s 3 $\frac{29}{32}$ d). The Government met the situation partly by stopping the sale of Council Bills in England and partly by offering to remit money to England on behalf of the Indian importers at the lower specie point by means of bills drawn on the Secretary of State called the Reverse Council Bills. The crisis was over before the close of 1908 but not without leaving a deep impression upon the Indian currency system. Henceforth the Indian currency could be contracted as well as expended by the draft selling mechanism and the gold value of the rupee could thereby be maintained between the gold points.

Thus was established the Gold Exchange Standard or, as some people choose to call it, the Sterling Exchange Standard.<sup>1</sup> On account of severe criticism of the currency and exchange policy of the Government, especially on the part of those who wanted a full-fledged gold currency standard, a Royal Commission on Indian Currency and Exchange, called the Chamberlain Commission, was appointed in 1913. The Committee supported the measure adopted by the Government for maintaining the exchange value of the rupee. They were definitely of the opinion

1 See L. C. Jain—*The Monetary Problems of India*—p. 10.

that the gold exchange standard was not only workable but, in the absence of any developed banking system, was admirably suited to the country on account of its cheapness. In view of the fact that heavy imports of gold from Australia and Africa had lately found their way either into the reserves or into ornaments and hoards, they considered a gold currency standard of the type contemplated by the Fowler Committee as absolutely *undesirable*. They saw no objection however, *in principle*, to the minting in India of sovereigns and half-sovereigns if Indian sentiment genuinely demanded it and the Government of India were prepared to incur the expense. The main recommendations of the Committee obviously lacked appreciation of the wishes of the people who had, since the crisis of 1907-8, been pressing for the increasing use of gold in circulation. Among the minor alterations proposed were the prompt selling of Reverse Council Bills and the abolition of the silver branch of the Gold Standard Reserve. The need for maintaining adequate reserve of gold and sterling securities in London for the purpose of converting internal currency into international or external currency was also emphasised.

To sum up, the pre-War currency system of India had the following features<sup>1</sup> :—

1. The internal currency consisted of the rupee which, although a token coin, also served as a standard of value, the notes (also the monopoly of the Government) and small subsidiary coins which were legal tender up to Re. 1 only.
2. The British sovereigns, which were not legal tender, provided means for external payment.

<sup>1</sup> Also see Keynes—*Indian Currency and Finance*, pp. 6-7.



3. The rupee, though unlimited legal tender, was convertible into gold only for exchange purposes at the rate of Rs. 15 for a sovereign (16d to a rupee).

4. The sterling (gold) value of the rupee was regulated between 1s.  $4\frac{1}{8}$ d (the upper specie point) and 1s.  $3\frac{29}{32}$ d (the lower specie point) through the sale of council bills and reverse council bills respectively.

5. With a view to working this system of regulating the value of the rupee, the Government maintained two reserves—the one mainly in rupees in India and the other in sterling in London. The Indian reserve consisted of the Indian portion of the Paper Currency Reserve, the Gold Standard Reserve and Treasury balances, while the reserve in England included the London branches of the Paper Currency and Gold Standard Reserves and the balances of the Secretary of State. Although each of these reserves had been created for a specific object, they were both available in case of need for the general object of supporting exchange and thus constituted practically one single fund.

A careful reflection will show that, under this system of Gold Exchange Standard, the rupee occupied a peculiar position. It was a token coin in so far as its face value was much higher than its intrinsic value and it also served as a standard coin for all practical purposes. It has, therefore, been called a '*Standard Token Coin*'. Moreover, the position of the rupee was identical with that of the note. Both could be used for buying and selling, for borrowing and lending and for paying taxes to the Government but neither of them was convertible into gold. There was, however, a slight difference in their intrinsic merits for while the note was

worth nothing, the rupee was, at any rate, worth the silver contained in it. It is, therefore, also true to say that the rupee was practically in the position of an inconvertible note with the only difference that, while one was printed on silver, the other was printed on paper.

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### SUMMARY

Before 1835, a large variety of gold and silver coins of different denominations were current in different provinces and caused great inconvenience to trade and industry. The Act of 1835 introduced a full-fledged silver standard for the whole of British India. The mints were thrown open for the free coinage of rupees which contained 180 grains of silver  $\frac{11}{12}$ th fine. The system worked successfully until 1874 when the price of silver began to decline. Cheap silver was offered to the Government for being minted into rupees and the prices began to rise. Considering the losses sustained by people earning fixed incomes and the Government, the Herschell Commission was appointed in 1893 and, acting on its recommendations, the mints were closed to the free coinage of rupees. The exchange value of the rupee in terms of the British sovereign was fixed at Rs. 15 to a sovereign.

The change proved successful. Prices and exchange came back to the normal and the Government appointed the Fowler Commission in 1898 to suggest changes in the then existing limping currency system. The Commission suggested a gold currency standard with sovereigns as standard coins and convertible into rupees at 1s. 4d to a rupee. The coinage of rupees was to be resumed on Government account only and the profit was to be carried over to a special reserve called the Gold Standard Reserve. The scheme of gold currency, however, did not materialise owing to the poverty of the people who showed marked preference for silver. A part of the Paper Currency Reserve was transferred to England to enable the Government to purchase more silver for minting rupees and the Government undertook to sell Council Bills for the purpose of enabling the British importers to pay their debts in India and Reverse Council Bills for the purpose of enabling the Indian importers to pay for their goods in England without having to remit

specie. This system, which was thoroughly approved by the Chamberlain Commission in 1913, is called the Gold Exchange Standard or more appropriately, the Sterling Exchange Standard because payments were actually made in sterling and not in gold. The position of the rupee under this system was peculiar. It was a token coin and yet, for all practical purposes, the standard coin of the country. It has, therefore, been called a 'Standard Token' Coin. For internal purposes the rupee was not convertible into gold. It has, therefore, sometimes been compared to the paper note which was also inconvertible and which differed from the rupee only because it possessed no intrinsic value. Hence the remark that, before the War, 'the rupee was in the position of an inconvertible note printed on silver.'

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### QUESTIONS

1. Explain the circumstances leading to the appointment of the Herschell Commission. What changes in the monetary system of India did it suggest and what were the results of those changes?
2. Why and how was the Gold Exchange Standard established in India?
3. What part did gold play in the Indian Currency system before the War?

[Delhi Inter. 1932]

[Delhi Inter. 1931]

## CHAPTER XI

### THE INDIAN CURRENCY SYSTEM—(*Continued*)

#### THE WAR PERIOD

The Great War began in 1914. In addition to the heavy toil of human life which it claimed, it shall also be remembered as a serious calamity which destroyed normal trade and commerce and threw the world exchanges in utter confusion. The countries actively engaged in War and their allies diverted their labour and capital to the manufacture of war material and allowed other essential articles to be imported from outside. The precious metals being scarce, many countries abandoned the gold standard and even those that stuck to it imposed heavy restrictions against the melting or export of gold without the permission of the government. To provide the governments with additional 'sinews of war' huge amounts of inconvertible notes were put into circulation with the result that depreciated currencies and steeply rising prices became the order of the day especially in the belligerent countries. The case of India was slightly different. Although as a member of the British Empire she shouldered her full share of responsibility and her currency system was irreparably damaged, her anxiety was not quite as great as that of many other countries. Let us study the course of events in India during the different phases of the War.

**1914-1915.** As soon as the War broke out the people were panic-stricken. Not being quite sure of the direction in which the wind might blow, a majority of them demanded the encashment of

notes into gold and the return of their Savings Bank deposits. The trade was abruptly thrown out of gear<sup>1</sup> and exchange showed signs of weakness. Fortunately, the Government soon succeeded in restoring public confidence by providing adequate facilities for the encashment of notes and for withdrawal of deposits from the Savings Banks. Reverse Council Bills to the extent of £ 9,000,000 were sold in support of exchange which became fairly steady between 1915-1916. It was also arranged that bills should be payable in London sixteen days after the departure of the weekly mail. The uncertainty of the delivery of the bills in London was by this means eliminated.

**1915-18.** The effects of the war conditions, however, began to be seriously felt in 1916. There was a marked reduction in imports due to the shortage of shipping and England's preoccupation in the production of war material. The value of exports, on the other hand, increased owing to the shipment of large quantities of food and raw materials to the Allies, thus making the balance of trade overwhelmingly favourable to India. The combined effect of these factors was to create a heavy demand for Indian

1 The heavy fall in the balance of trade can be seen from the following table :—

Year	Net Exports (in thousands of £)
1909-10	... 47,213
1910-11	... 53,615
1911-12	... 59,511
1912-13	... 57,020
1913-14	... 43,753
1914-15	... 29,108
1915-16	... 44,026
1916-17	... 60,843
1917-18	... 61,402
1918-19	... 56,540

currency which was all the more accelerated by the enormous payments which the Government of India had to make on behalf of His Majesty's Government. This demand was partially met by the extensive coinage of rupees<sup>1</sup> and by the increase of note-issue without the usual metallic backing. The fiduciary portion of the reserve was increased from Rs. 20 crores to Rs. 120 crores and new notes of Re. 1 and Rs. 2½ were put into circulation<sup>2</sup>. Nickel coins of denominations of 2 annas, 4 annas and 8 annas were issued in order to economise the use of silver. But, just at this time when the Government of India were pooling their resources to tide over monetary stringency, there came an unprecedented rise in the price of silver. Due partly to the increased cost of production and comparative shortage of supply but mostly to an unusually keen demand for it all over the world, the price of silver rose from 27d per ounce in 1915 to 43d in 1917—a price at which the exchange value of the rupee at 1s. 4d was equivalent to its bullion value<sup>3</sup>. In September 1917 the price rose to 55d per ounce and to 78d in December 1919. Obviously, it became profitable for the people to melt rupees and to sell them as bullion<sup>4</sup>. Gold also suffered the same fate. Owing to keen demand, especially at a time when its production was seriously curtailed, its price went up too. All the available gold of the world found its way into the neutral countries and financing allies leaving practically nothing for the fighting countries to put in the reserves as backing for note-issue. In view of

1 With the help of 300 million ounces of silver purchased in the market and 200 million ounces placed by U.S.A. at the disposal of the Government.

2 Also see Chapter XIII.

3 See p. 89. *supra*.

4 Notwithstanding its prohibition by law.

the shortage of the precious metals, an Ordinance was promulgated on June 29, 1917 requiring all gold imported into India to be sold to the Government at a price based on the sterling exchange value of the Indian rupee. The gold thus acquired was put in the reserve as a backing for the issue of additional notes. A branch of the Royal Mint was opened in Bombay in August 1918, where 2,110,000 gold mohurs and 1,295,000 sovereigns were coined. The melting of silver was strictly prohibited.

The exchange standard of India before the War depended for its success upon Government's ability to maintain an *artificial* value of the rupee and to prevent it from rising above or falling below fixed rates. The legal ratio between the rupee and sterling was normally kept steady by means of an *adequate* supply of internal and external currencies and reserves according to the requirements of trade. On account of the extraordinary conditions mentioned above the Government found it impossible to work the system in the normal way. The weekly sales of Council Bills were restricted to about Rs. 120 lakhs at a price rising with the sterling value of silver. The exchange rose to 1s. 5d in 1917, touched 2s. 4d in December 1919<sup>1</sup> and the monetary system, which had worked so successfully before the War, failed.

1 The following table shows a rapid increase in the rate of exchange between 1917-1919, especially towards the concluding years of the War :—

January, 1917	...	1s. 4½d.
August, 1917	...	1s. 5d.
April, 1918	...	1s. 6d.
May, 1919	...	1s. 6d.
August, 1919	...	1s. 10d.
September, 1919	...	2s. 0d.
November, 1919	...	2s. 2d.
December, 1919	...	2s. 4d.

It has already been mentioned that, in the absence of gold and silver, the Government had perforce to issue notes in huge quantities without providing the necessary metallic cover.<sup>1</sup> The currency was, therefore, almost on the verge of inconvertibility and its fate hung continuously in the balance. Thanks to India's position as a financing ally, the purchasing power of her currency instead of going down actually went so far up as to be almost double of the pre-War parity. But for this privilege the value of her notes would have been reduced to less than that of the paper on which they were printed (as in Germany).

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#### SUMMARY

The destructive War of 1914 shook the currency systems of the world to their foundations. The main difficulties were caused by the stoppage of production on one side and drastic inflation of currency on the other. India suffered in common with other countries.

During the first year of War (1914-15) the people in India were panic-stricken. They rushed to the Postal Savings Banks to withdraw their deposits and presented their notes to the Government for being converted into gold. The balance of trade became less favourable than before. The Government faced the situation very boldly and public fears were set at rest within a short time.

From 1915 onwards, the imports of India declined whilst her exports increased enormously. The demand for India's currency abroad increased but more rupees could not be minted owing to an unprecedented rise in the price of silver. Nor was gold available either for coinage or for providing metallic cover for note-issue. The dealings in precious metals on private account were prohibited as also the melting of rupees. In view of the scarcity of currency the sale of Council Bills in England was *restricted* to about 120 lakhs a

<sup>1</sup> Percentage of metallic backing decreased from 78 per cent in 1914 to 35 per cent in 1919.



week and they were sold not at the pre-War rate of exchange but at prices varying with the price of silver. More currency was created by raising the limit of the fiduciary portion from Rs. 20 crores to Rs. 120 crores and by issuing new notes of Re. 1 and Rs. 2½. It will be observed that the pre-War gold exchange standard which required the maintenance of a fixed rate of exchange completely broke down during the War when the Government *refused to sell Council Bills upto unlimited amounts and at fixed rates* and when the exchange was allowed to rise from 1s. 4d in 1914 to 2s. 4d in 1919.

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### QUESTIONS

1. Account for the breakdown of foreign exchanges in almost all countries of the world, including India, during the time of the Great War.

[Delhi Inter. 1931]

2. Describe the difficulties experienced in the management of Indian currency and exchange during the War period.

[Delhi Inter. 1928 and 1932]

3. Account for the violent fluctuations in the rupee—sterling exchange during the last Great War.

## CHAPTER XII

### THE INDIAN CURRENCY SYSTEM—(*Continued*)

#### THE POST-WAR PERIOD

##### 1919-1926. The Babington Smith Committee.

On the termination of War the review of the Indian currency was entrusted to the Babington Smith Committee in May 1919. The Commission were inclined to suggest a gold currency standard but, in view of the great scarcity of precious metals, they recommended the re-introduction of the gold exchange standard with a genuine warning that should public opinion express itself in favour of the circulation of gold coins, the demand should be ungrudgingly conceded. In view of the phenomenal rise of exchange during the War, they further recommended that the sovereign should be made legal tender in India at the revised ratio of Rs. 10 to one sovereign (Re. 1=2s)<sup>1</sup>, although the notification of the Government undertaking to give rupees for sovereigns should be withdrawn. The high ratio was recommended because the Commission believed that the price of silver would continue to be high and that if the exchange value of the rupee was fixed at 2s the rupee would be

<sup>1</sup> The rupee was thus made equal to 11·30016 grains of fine gold. Since dollar then was the only coin made of gold, this system has sometimes, erroneously, been called the Dollar Exchange Standard.

It must be emphasised that the rupee was linked to *gold* and not to the pound sterling. Gold coin was not in circulation in England and Treasury notes formed the great bulk of the full legal tender currency and were not convertible into gold. The pound sterling was, therefore, at a discount and 2s gold was equal to about 3s sterling. Also read Kale—*Indian Economics*—p. 543, foot-note.

once more established as a token coin and it would be possible for the Government to control and regulate the amount of currency in circulation. It was also preferred to the pre-War parity (1s. 4d) because the latter was expected to raise prices and entail great hardship on the poorer classes. It was regarded as advantageous to Indian producers as it would keep down the cost of imported materials and machinery in rupees and would keep wages down. The fear that exports would be discouraged was not regarded valid because, owing to the world shortage of raw materials and foodstuffs, the demand for Indian products abroad was very great. The Government finances were to gain enormously from the high level of exchange because it was calculated that there would be a saving of more than Rs. 12 crores in the remittance of Home Charges.

Among other recommendations of the Committee the following deserve special mention :—

(1) A gold mint should be opened in Bombay for the coinage into sovereigns of gold tendered by the public.

(2) The import and export of gold should be freed from Government control as soon as the change in the statutory rate to Rs. 10 per sovereign had been effected.

(3) The prohibition of private import and export of silver should be removed.

(4) The Gold Standard Reserve should contain a considerable proportion of gold and the remainder should consist of securities issued by Governments within the British Empire, other than the Government of India, and maturing within 12 months. Fifty per cent of the Gold Reserve was to be held in India.

The Government accepted most of these recommendations and removed all war time restrictions. They instructed the treasuries and currency offices to accept sovereigns and half-sovereigns at the rate of Rs. 10 and Rs. 5 respectively but not to issue them. As the market price of the sovereign continued to be above Rs. 10 it never functioned as currency at the new ratio. The gold mint was not opened either.

**The Fate of 2s Rate.** The problem of ratio also proved elusive. Gold was then selling at Rs. 22½ per tola whereas according to the new ratio the price of gold ought to have been Rs. 15-14-0. In view of such a great disparity it was clearly difficult, if not impossible, to maintain the ratio of 2s gold. Moreover, the balance of trade and prices which were so favourable during the War, became equally unfavourable after 1919. "Imports had increased owing partly to the increased demand for piece-goods, the stock of which had run low at the end of War, and partly to the stimulating effect of the rise in exchange on demand. Exports, on the other hand, had declined owing to a combination of adverse circumstances. In the first place, Japan, one of the chief buyers of Indian cotton, was obliged to reduce her purchases because of a financial crisis there. Secondly, the demand for jute, hides and tea fell off partly because of the large stocks accumulated in England and elsewhere and partly because of the industrial uncertainty prevalent in the markets for these goods. Thirdly, India lost some of her best customers. Owing to various economic and political troubles, the countries of Central Europe were not then in a position to pay for what they wished to purchase."<sup>1</sup> The result was that while in August, 1919 the

1 Chablani—*Indian Currency and Exchange*—p. 92.

balance of trade was favourable to the extent of 11 crores of rupees, in August 1920 it was unfavourable by about the same amount. Similarly, although the prices had started falling, they were falling faster in U. S. A. and still faster in England with the result that while the value of the rupee in terms of gold fell, it fell all the more in respect of sterling. The post-War boom came suddenly to a close. The advantage was taken of the high exchange by the European community to remit to England the great profits which it had made during the War. Indian importers who would ordinarily have waited for months to make remittances to England hastened to do so to avail of the favourable rate. There was a regular speculation in exchange. Those who were convinced that the exchange would fall found it easy to make profits by first converting rupees into sterling at the high rate and then turning sterling back into rupees when the exchange came down. Such a heavy demand for sterling caused the value of the rupee (in respect of sterling) to fall. The exchange could not be maintained at 2s gold (which at that time meant nearly 3s sterling) although the Government offered to sell Reverse Council Bills to an unlimited extent. When the attempt to hold the exchange at 2s gold failed, efforts were made to hold it at 2s sterling. But these also failed. Between 1919 and 1922, Reverse Councils<sup>1</sup> to the extent of £55.5 millions were sold to no avail till at last the Government admitted their inability to maintain exchange at any rate. In 1922 they refused to sell any more sterling drafts on London. "The collapse of exchange within twelve months from the level of 2s. 4d prevailing in April 1920

1 These bills were met by selling sterling securities and treasury bills belonging to the Paper Currency Reserve. These securities had been bought at Rs. 15 to the £ but sold at Rs. 7 to Rs. 10 to the £ and there was thus a loss of about Rs. 35 crores.

to blow rs. 3d was critical for importers many of whom had ordered goods when exchange was high without fixing their exchange and who were unable or unwilling to settle at the low rate prevailing when the goods arrived. At the close of the year the Indian ports remained congested with imported piece-goods, motor cars and other articles of which delivery had not been taken. In further contrast to the preceding year there has been an almost continuous return of rupees from circulation, a symptom of the general stagnation of trade."<sup>1</sup>

Before 1922-25, therefore, there was theoretically no standard although the Government, helped by the revival of trade, succeeded in linking the rupee to sterling at rs. 6d to a rupee. In the meanwhile, aroused by the serious harm done to trade by frequent changes in the monetary standard, the people had already begun to clamour for a full-fledged gold currency standard.

**1925-31: The Defects of the Gold Exchange Standard.** In 1925 the Indian currency came under the searching examination of the Hilton-Young Commission. The Commission pointed out the following defects in the pre-War Gold Exchange Standard of India :—

- I. The Government had the monopoly of metallic and paper currency whose value in respect of the international currency (gold) was maintained through the complicated device of Council and Reverse Council Bills. The system was, therefore, far from simple and its complete mechanism was not easily intelligible to a layman in the street.

<sup>1</sup> *Report of the Controller of Currency for 1920-21.*

2. It did not secure automatic expansion and contraction of currency. The Government had great incentive to inflate currency but there was no machinery with which to pump out superfluous currency except that of Reverse Council Bills<sup>1</sup> which were only sold on those rare occasions when the balance of trade was unfavourable to India.
3. It did not provide natural correctives to exchange such as are possible in the case of a complete gold standard when the gold can go in and out of the country and thereby affect price levels.
4. Its stability was always threatened by a rise in the price of silver because the standard token coin, *viz.* the rupee, was liable to disappear if the price of silver rose above the melting point (as during the War).
5. There was a cumbrous duplication of reserves (currency and banking reserves) with a dangerous division of responsibility for the control of the currency policy which, in other countries, is vested in the hands of a Central Bank.
6. Since it could be easily managed and artificially manipulated by the Government it failed to inspire public confidence.

The supporters of the old system, however, maintained that the Gold Exchange Standard was

<sup>1</sup> Even when Reverse Council Bills were sold, the Government failed to effect corresponding contraction of currency because the money was never locked out of circulation. See the *Report of the Hilton-Young Commission*, paras 16-17.

not introduced by any body as such but that it was the result of a gradual process of evolution. Far from being artificially retained by the Government for their own advantage, it was admirably suited to the peculiar needs of poor India<sup>1</sup> especially because it economised the use of precious metals and enabled a fairly stable rate of exchange to be maintained with countries on the gold standard.

These arguments are not very convincing. As against the argument that the gold exchange standard is very much more economical than the gold standard in avoiding the costly locking-up of gold or the wasteful use of gold in circulation, it may be pointed out that the result of the working of the system has been just the reverse of what its advocates claim for it. "From the point of view of this country, the savings on the coinage of rupees under the Gold Exchange Standard, which now amounts to £40,000,000, are not available either for the development of our credit institutions or for the development of our nation-building departments as these savings are located and invested in London. The Gold Standard Reserve Fund also cannot be used for the purchase of industrial equipment in the world market as it is solely intended to maintain the stability of foreign exchange..... Far from economising the use of gold and giving the country the benefit of cheaper medium of exchange, the Gold Exchange Standard has, in actual working, resulted in the most *foolish, extravagant and wasteful dissipation of the country's gold resources*, both internally and externally."<sup>2</sup> Referring to the difficulty of maintaining an unbiased gold

1 For other arguments in favour of gold exchange standard revise Chapter IX.

2 Wadia and Joshi—op. cit. pp. 269—271.



exchange standard, Dr. Canan wrote:— "The percentage of administrators and legislators who understand the gold standard is painfully small, but it is and is likely to remain ten or twenty times as great as the percentage that understands the Gold Exchange System. The possibility of a Gold Exchange System being *perverted to suit some corrupt purpose* is very considerably greater than the possibility of the simple gold standard being so perverted."<sup>1</sup>

It must also be remembered in this connection that the supreme consideration with the Government has all along been to prevent a *rise* in the *sterling value* of the rupee rather than the stability of the rupee *in terms of prices in India*. Chabiani is, therefore, right when he says that the "Indian currency system was a *dependent* standard and a clumsy one at that."<sup>2</sup>

**The Sterling Exchange Standard Rejected.** Having rejected the Gold Exchange Standard, the Commission considered the advisability of recommending the sterling exchange standard. This system could be established by requiring the currency authority to sell rupees for sterling without limit at the upper specie point of a fixed parity and to sell sterling for rupees at the lower gold point of the same parity. It would have been *cheap* and *automatic* in its working but the commission rejected it on the ground that it contained all the defects of the gold exchange standard and left Indian currency, exchange and prices to the mercy of the English currency system. That their fears were not ill-founded, has been amply borne out by what happened after September

1 See his Foreword to *The Problem of the Rupee* by B. R. Ambedkar.

2 *Studies in Indian Currency and Exchange*—p. 92.

1931 when sterling was divorced from gold and the Indian currency suffered in common with the depreciated sterling.<sup>1</sup>

**Commission's Objections Against Gold Currency Standard.** The Commission were also opposed to the introduction of gold currency standard<sup>2</sup> on the ground that it was difficult, if not impossible, to obtain the required supplies of gold. The American and English evidence left no doubt about this point. "Both authorities view the proposal with alarm on the grounds that it would retard the progress of monetary reconstruction in Europe, would upset world prices and would be fundamentally harmful to India and to the rest of the world."<sup>3</sup> They also feared that an increase in the demand for the yellow metal would raise *its* price and thus *accentuate the downward trend of prices* all over the world. They showed great concern for China and the Indian agriculturists who had put their savings in silver and stood to lose heavily by its demonetisation. The Government were also expected to lose as their reserves were sure to depreciate in value. Moreover, at a time when the rest of the world was centralising its gold resources in the hands of central banks, it seemed to be preposterous why the people should clamour for the presence of gold coins in circulation although the stability of currency could be achieved without them.

**The Gold Bullion Standard.** Arguing that it was possible to have a true gold standard even without putting gold coins in circulation, the

1 See pp. 175—176.

2 Which was proposed by the Government of India (Blackett Scheme) and supported by several eminent economists. This scheme in particular was rejected on account of the unreliability of its estimates.

3 *Hilton Young Commission Report*, para 51.

Commission recommended the adoption of the Gold Bullion Standard on the lines followed in England in 1925. They proposed "that the ordinary medium of circulation in India should remain, as at present, the currency note and the silver rupee and that the stability of the currency in terms of gold should be secured by making the currency directly convertible into gold for all purposes but that gold should not circulate as money." Under the Commission's scheme, rupees and notes were to legally cease to be convertible into each other and a legal obligation was to be imposed upon the Central Bank, suggested by them, to buy and sell gold (at rates determined with reference to the gold value of the rupee, viz., Rs. 6d) in amounts of not less than 400 ounces—no restriction being imposed as to the purpose for which the gold was to be required. Gold was thus to be made the *real* standard of value which, unlike the pre-War gold exchange standard, would be entirely *independent* of the sterling and other groups of currencies. It was further claimed that the scheme represented an absolute gold standard as under it the gold bars were to be given not for export but for *any* purpose. Some critics maintained that under the Gold Bullion Standard token currency will be convertible into gold only for export and not for all purposes.<sup>1</sup> They also pointed out that under the Gold Exchange Standard notes were at least convertible into a better currency, namely, rupees, but under the Gold Bullion Standard they were, to all intents and purposes, inconvertible. They, however, forgot that the *very fact of convertibility* would be an effective check on the Central Bank's power of inflation and remove the very cause that induces most people to present their notes for

1 Brij Narain—*Indian Economic Life*—p. 242.

conversion into better currency viz., the depreciation of token coins. Moreover, it would remove the long standing anomaly of one token coin being convertible into another token coin. The convertibility of the rupee and the paper currency into actual gold being guaranteed, it was believed that the confidence of the public would be enlisted and the temptation to hoarding would be successfully checked. In order further to convince the public of the solidity of the gold basis of the rupee, the Central Bank was to issue Gold Bullion Certificates of one tola or less redeemable in 3 or 5 years in legal tender currency or gold at the option of the holder. The holder was to be given facilities to get them encashed at any time during their currency at certain rates of discount but until the date of maturity they would be paid in legal tender money and not in gold.

It was, therefore, expected that the Gold Bullion Standard would be more *simple, certain* and *automatic* in its working than the gold exchange standard, that it would *promote habits of banking and investment*, and that it would be *free* from the threat implied in the rise in the price of silver.

**The Ratio Problem.** It has already been pointed out that the attempt to give a high external value (2s gold) to the rupee in 1919 ended in smoke in 1922. The adverse balance of trade and high prices continued for more than a year and the exchange further declined to below 1 shilling. In 1922-23, however, the balance of trade improved in favour of India with the result that the exchange touched rs. 4d in September 1924, rose to rs. 6d in May and remained firm at rs.  $6\frac{5}{32}$ d for the next two years. The Indian prices fell from 176 in 1922 to 159 in 1925 and incidentally coincided with the level of world gold prices which was

also about 159. In 1926, prices fell to 148 both in India and in the United Kingdom.

**Arguments for 1s. 6d.** Arguing that during the period of change there was a mutual adjustment of prices and exchange, the Hilton-Young Commission recommended that the rupee should be stabilised in relation to gold at the rate of 1s. 6d for the rupee.<sup>1</sup> They also suggested that the wages of industrial and agricultural labourers had been adjusted to the new level of prices and that it was not desirable to produce a concealed reduction in wages by adopting a lower ratio (implying a higher level of prices). The Commission contended that reversion to 1s. 4d would bring about a rise of prices by  $12\frac{1}{2}$  per cent which would dislocate commerce and trade and substantially reduce the purchasing power of the people earning fixed incomes. They admitted that the burden of land revenue in terms of purchasing power had increased because many of the current settlements were made when exchange was at 1s. 4d but they were of the opinion that the loss of the agriculturists had been more than made up by the high level of prices during and after the War. Other contracts were either short period contracts, that is, they were entered into when the exchange was at (or near) 1s. 6d or they were concluded at a time when exchange was unstable and it was impossible to do absolute justice to the creditors and debtors by fixing on any particular rate of exchange.

**Arguments for 1s. 4d.** Sir Purshottamdas Thakurdas, a member of the Commission, in his elaborate Minute of Dissent, challenged these statements and stressed the desirability of stabilising exchange at 1s. 4d. He held that the

1 Thus making the rupee equal to 8.47 grains of fine gold.

adjustment between the Indian and world prices was not complete and that the ratio of rs. 6d was artificially worked up by deliberately contracting currency. He also pointed out that, until adjustment was complete, the rs. 6d ratio conferred an indirect bounty of  $12\frac{1}{2}$  per cent on the foreign manufacturer at the cost of the Indian producer and aggravated the distress of the debtors, including the agriculturists, who had to give more purchasing power in settlement of debts owing to them. He admitted that rs. 4d would increase the burden of Home Charges but thought that the loss of Government would be more than made up by increased revenue from custom duties and income tax which was inevitable if industries were adequately protected against foreign competition. As to labour, the then existing rate of wages was sufficiently high to cover a possible rise of prices caused by the adoption of rs. 4d. In any case, there was compensating advantage of continuity of employment due to the fact that the lower ratio would ensure greater prosperity to industry and agriculture while the higher ratio was sure to injure both. He also blamed the Government for throwing away an opportunity of restoring the exchange to the pre-War ratio of rs. 4d in September, 1924 when the exchange had actually touched 16d. Other arguments urged in favour of rs. 4d were that it was a natural and a *de facto* rate and that while at rs. 4d the sovereign is equal to Rs. 15, at rs. 6d it is equal to Rs. 13-5-10 which is difficult to remember.

**The Ratio Controversy Examined.** It is rather interesting to note that the exponents of the new ratio have made use of the same statistics to support their case as the opponents have used to demolish it showing clearly that index numbers

are by no means an infallible guide for the study of such intricate problems.<sup>1</sup>

The whole discussion virtually centred round *adjustments*—the adjustment of Indian prices to world prices and the adjustment of wages and contracts, etc., in India to the then-existing level of Indian prices. It can scarcely be denied that the adjustment was not complete but it should also be admitted that under the conditions then prevailing it was easier to adopt rs. 6d than rs. 4d. The Commission failed to adduce sufficient statistical evidence to prove that the long period contracts were not likely to be affected by the high ratio or that agricultural wages were in adjustment. In fact, they gave away their case by attempting to minimise the losses of agriculturists by saying that they had already been compensated by heavy profits made by them since 1914.

The supporters of 16d ratio, similarly, could not establish the fact of any substantial contraction of currency. They also failed to recognise that the loss sustained by the manufacturers and the agriculturists was small and transitory because it was likely to be offset by a corresponding (and even greater) fall in the price of implements, raw materials and other articles of daily consumption. The claim that rs. 4d was a natural and *de facto* rate was obviously untenable because, so long as the rupee is a token coin, the question of a natural rate cannot arise. Any rate, provided it can be successfully maintained over a fairly long period of time, has the same right to be called 'natural' as rs. 4d. The argument that at rs. 6d the rupee would be equal to Rs. 13-5-10 is also fantastic. Besides, it loses sight of the fact that under the

1 See the Report of the Hilton-Young Commission—paras. 178-179.

recommendations of the Hilton Young Commission the sovereign ceases to be legal tender.

**Conclusion.** Considering that rs. 6d had been maintained for over five years (1922-26) and that a sudden lowering of the ratio would have involved excessive economic disturbance, the Commission were thoroughly justified in recommending its stabilisation at that rate. Nevertheless, there is no gainsaying the fact that rs. 4d is calculated to promote the interest of a larger section of the community more than any higher rate. It also assimilates the Indian currency system to that of England much more easily than any other rate. At 16d a sovereign would be equal to 15 rupees and this rate of 1 to 15 was the rate at which the gold mohur formerly exchanged for rupees. The rupee contains 16 subsidiary units called annas, therefore, one anna would become equivalent to one penny. The anna is equivalent to 4 pice which would give to the pice and the farthing the same value; and finally, the Indian pice is equivalent to three pies, making the pie equal to one-third of a farthing. "When one considers the close fiscal and commercial ties existing between India and the mother country and the prospect at the time that the sovereign would soon become an important coin in India's monetary system, this close assimilation of sovereign and the rupee units and their fractions will be seen to be a meritorious feature of the 16d rate."<sup>1</sup> The Government should, therefore, strive to reinstate it as and when a suitable opportunity offers itself.<sup>2</sup>

**The Act of 1927.<sup>3</sup>** The scheme sanctioning

1 Kemmerer—*Modern Currency Reforms*.

2 One such opportunity presented itself in September 1931 when England abandoned the gold standard and the Government were free to change the ratio in terms of sterling.

3 For an excellent summary of the Act read L. C. Jain—*The Monetary Problems of India*, pp. 33-35.



the establishment of a Central Bank, which was to be a necessary counter-part of the Gold Bullion Standard, was turned down by the Legislative Assembly in 1927 although the Gold Bullion Standard itself was approved. Act No. IV of 1927 fixed the gold value of rupees and notes at 8·47512 grains for one rupee and imposed a legal obligation on the Government to buy gold at a price of Rs. 21-3-10 per tola of fine gold in the form of bars containing not less than 40 tolas and to sell, for legal tender currency, gold for delivery at the Bombay Mint, *or at the option of the Government, sterling* in London in amounts of not less than 400 ounces (1,065 tolas). A rate of 1s. 5<sup>49</sup>/<sub>64</sub>d was notified as Government's selling rate for sterling to meet these obligations. This virtually committed the Government of India to the Gold Bullion Standard at the rate of 1s. 6d per rupee although it was strictly speaking a Sterling Exchange Standard.<sup>1</sup>

**Failure of the Gold Bullion Standard—The Sterling Exchange Standard.** The new standard was better than the pre-war gold exchange standard inasmuch as there was a statutory gold parity for the rupee and a statutory obligation on Government with regard to the purchase and sale of gold. But it still retained most of the old characteristics which had so strongly been condemned by the Hilton

1 Because by reserving to themselves the right of converting token currency into gold or sterling, the Government *really* aimed at the sterling exchange standard.

"But it is fair to point out," says Dr. L. C. Jain, "that so long as sterling did not go off the gold parity, the sterling exchange standard was as good or as bad as the gold exchange standard. Further, if Government chose to exercise the further option open to it of offering gold in exchange for rupees, India would have had, in point of fact, if not in law, a gold standard. Thus the standard of 1927, though a sterling exchange standard, was capable of becoming a gold standard and certainly indicated that the gold standard was the ideal of Government".—*The Indian Monetary Problems*, p. 35.

The real intentions of the Government became apparent in September 1931 when instead of converting rupees into gold they offered to convert them in sterling.

Young Commission *viz.*, the conversion of one token currency (silver rupee) into another (paper note), the duplication of reserves and the separation of currency from credit control.

The attempt to link the rupee to sterling in the guise of the Gold Bullion Standard proved a dismal failure and the Government threw overboard all pretensions of putting the rupee on gold parity in 1931. In the beginning of that fateful year many European countries withdrew their deposits from London. Faced with a serious budget deficit on one side and the speedy exhaustion of its gold resources on the other, the British Government authorised the Bank of England to suspend the operation of the Gold Standard Act of 1925. The gold standard was thus suspended in England. This decision was arrived at late in the evening of the 21st September 1931 and the following morning the Viceroy, on the advice of the Finance Member, issued Ordinance No. VI of 1931 temporarily relieving the Government of India of their obligation to sell gold or sterling. To the great surprise of every body in this country, within a few hours of this decision being taken by the Government, Sir Samuel Hoare informed a sub-committee of the Round Table Conference that the rupee would continue to be maintained at 18d sterling. Evidently, there was a very wide difference of opinion between the Government of India and the Secretary of State. In order, therefore, to acquaint the Secretary of State of their views in the matter and to prevent all panicky developments, the Government of India declared a compulsory bank holiday. On the resumption of work on the 25th September the Government promulgated another Ordinance repealing that of the 21st and authorising the Government to sell gold or sterling for

genuine trade requirements only and for reasonable personal or domestic purposes.<sup>1</sup>

The action of the Government in linking the rupee to sterling instead of gold was greatly resented by the Indian people. The criticism was not merely sentimental but was based on several serious considerations. In the first place, it made the prices in India dependent upon British prices which were not likely to be very stable after the abandonment of the gold standard. Secondly, it placed India's import trade with gold standard countries at a disadvantage as compared to her trade with countries which were divorced from gold. It only helped England to sell her products into India at a greater advantage over her European rivals.<sup>2</sup> Thirdly, it necessitated the sale of Reverse Council Bills which exhausted the Indian reserves in England. But, by far the worst consequence of linking the rupee to sterling was the export of gold.

**The Export of Gold.** The traffic in gold is a normal feature of international trade. Every country imports and exports some every year but some import more than what they export and some export more than what they import. Owing to her favourable trade balance, the balance of trade in gold is generally in favour of India but,

1 The Gold and Sterling Regulation Ordinance of 1931 was cancelled in January 1932 which meant that the Currency Act of 1927 again came into operation. But so long as sterling remains cut off from gold the Indian monetary standard remains a sterling exchange standard. The cancellation has simply taken away the restrictions on exchange transactions but it has in no way changed the essential characteristic of the Indian system as being linked to sterling which is divorced from gold.

2 "With a rupee equal to 1s. 6d sterling which bought less American or French gold currency than before, it became less profitable for an Indian importer to import goods from America or France which were still on the gold standard, than for instance, from England which had departed from it." Jain—*op cit*, p. 45.

during the last few years, more than Rs. 300<sup>1</sup> crores worth of gold has been exported. Some of this has been sent out immediately after the economic depression in 1928 from the Punjab and United Provinces which were more severely affected by the crisis and is called *distress gold* but the major portion has been exported after September 1931. The price of gold rose by about Rs. 10 per tola and the people parted with it merely out of considerations of making profit.<sup>2</sup> Ever since the flight of gold began the people of India urged upon the Government the immediate necessity of stopping it but nothing of the kind has been done so far because the Government expect many advantages from the export of gold. Their case may be summed up thus :

- ★ (1) There is nothing abnormal about the present export of gold because it is a normal feature of the trade of the country.
- (2) Gold exports have led to an improvement in the credit of the Government. This has enabled the Government to stabilise exchange by purchasing sterling at favourable prices. It has also enabled the Government to pay off the 15 millions sterling debt and to reduce their floating debt in India by creating fresh currency required to pay for the gold.

1 The exact amount was Rs. 314·6 crores for the last 7 years—1931-38.

2 It should be remembered that a rise in the price of gold *alone* was not enough to enable people to export their gold to other countries. If a rise in the rupee price of gold in India had been exactly offset by a depreciation of the rupee, there could not have been any gain from such export. Gold was exported because a rise in the price of gold in India brought forth a large supply of *distress gold* in the market which did not allow the price of gold in India to rise to the same extent as it would have risen in the absence of distress gold. In other words, though the price of gold had risen in India as well as outside, the *extent of the rise* was smaller in India than in other countries with depreciated currencies. Hence the depreciation of the rupee in terms of gold being smaller than its depreciation in terms of any stable currency like dollar, it was clearly profitable to export gold.

- (3) Gold exports have strengthened India's public reserves. Although there was practically no increase in the quantity of gold in the reserve, its value at the market rate increased by about 5 crores of rupees.
- (4) Gold exports have enabled persons, especially the agriculturists, to live upon their past savings and to make a huge profit into the bargain.
- (5) Gold exports have encouraged the flow of international trade. They have not only helped India to buy more foreign goods but have increased the purchasing power of her potential customers.

Some of these arguments appear to be frivolous. India may have exported gold in the past, but it is an open secret that she has always imported more gold than what she has exported during the last ten years except, perhaps, 1921-22 as the following table will show :—

(value in crores of rupees)

	Import	Export	Net Import+ „ Export—
Average for 1910-11 to 1914-15	29.92	4.57	+25.35
Average for 1915-16 to 1919-20	19.64	6.23	+13.41
Average for 1920-21 to 1924-25	36.45	7.74	+28.71
1925-26	35.22	.37	+34.85
1926-27	19.50	.10	+19.40
1927-28	18.13	.03	+18.10
1928-29	21.21	.02	+21.19
1929-30	14.23	.01	+14.22
1930-31	13.24	.49	+12.75
1931-32	2.79	60.77	-57.98
1932-33	1.31	66.84	-65.53
1933-34	1.09	58.15	-57.06
1934-35	.71	53.25	-52.54
1935-36	.94	38.30	-37.36
1936-37	1.60	29.45	-27.85
1937-38	1.56	17.90	-16.34
Total for 21 years from 1910-11 to 1930-31	551.67	93.81	+457.86
Total for 7 years from 1931-32 to 1937-38	10.06	324.68	-314.62

Young Commission *viz.*, the conversion of one token currency (silver rupee) into another (paper note), the duplication of reserves and the separation of currency from credit control.

The attempt to link the rupee to sterling in the guise of the Gold Bullion Standard proved a dismal failure and the Government threw overboard all pretensions of putting the rupee on gold parity in 1931. In the beginning of that fateful year many European countries withdrew their deposits from London. Faced with a serious budget deficit on one side and the speedy exhaustion of its gold resources on the other, the British Government authorised the Bank of England to suspend the operation of the Gold Standard Act of 1925. The gold standard was thus suspended in England. This decision was arrived at late in the evening of the 21st September 1931 and the following morning the Viceroy, on the advice of the Finance Member, issued Ordinance No. VI of 1931 temporarily relieving the Government of India of their obligation to sell gold or sterling. To the great surprise of every body in this country, within a few hours of this decision being taken by the Government, Sir Samuel Hoare informed a sub-committee of the Round Table Conference that the rupee would continue to be maintained at 18d sterling. Evidently, there was a very wide difference of opinion between the Government of India and the Secretary of State. In order, therefore, to acquaint the Secretary of State of their views in the matter and to prevent all panicky developments, the Government of India declared a compulsory bank holiday. On the resumption of work on the 25th September the Government promulgated another Ordinance repealing that of the 21st and authorising the Government to sell gold or sterling for

The first procedure could have benefited none and only injured the genuine sellers, especially the victims of the trade depression. The second alternative would have launched the Government into a speculative business in a commodity whose price was fluctuating. We can thus pin our faith in India's lust for gold which has earned her great notoriety. As soon as trade conditions became more favourable, let us hope, the lost gold will flow back to us in increasing amount.

In 1938-39, India exported gold for Rs. 13·79 crores; and the gold earmarked with the Reserve Bank on account of purchasers abroad was Rs. 10·19 crores. The exports in 1939-40<sup>1</sup> were, curiously enough, on a vaster scale and the Reserve Bank's purchases of the metal for foreign constituents, though smaller, continued to persist. Between April 1939 and January 1940, India parted with valuable yellow metal for Rs. 42·02 crores and received in its place nothing but paper money in sterling; and this was done during a period when India's favourable balance of trade in merchandise was Rs. 78·03 crores and when, ordinarily speaking, India should have got gold from foreign countries.

This loss of gold for Rs. 42·02 crores in favour of foreign countries cannot be justified in a period of war and in conditions in which its place is being taken by more paper sterling. It is, therefore, suggested that the Government should adopt four definite lines of policy. *First*, export of gold must be banned. *Second*, no more gold should be bought in India on account of foreign constituents of the Reserve Bank. *Third*, the dollar balances

<sup>1</sup> During the ten months, April 1939—January 1940, gold worth Rs. 33·94 crores was exported and the Reserve Bank bought gold in India and earmarked for overseas' clients to the extent of Rs. 9·08 crores.

accruing from our favourable merchandise balance of trade<sup>1</sup> with the U. S. A. must be utilised for the purchase of gold in America. *Fourth*, the Reserve Bank must be enabled, by a change in the statute, to value its gold at current market rates; and the Bank must be asked to buy gold for its reserve both in India and in America.

**The Present System.** It will be seen that India, at the present time, is on the sterling exchange standard. The Government of India have given an artificial value to the rupee in terms of sterling at Re. 1=18d and maintain this parity between the specie points through the sale of sterling. The rupee is a token coin yet it is the principal medium of exchange and standard of value. Hence, it is still a standard token coin. Internally it is convertible into paper notes and other subsidiary currency and externally into sterling neither of which is convertible into gold. It performs all the functions of a currency note and differs from it only in that while the note is printed on paper, the rupee is printed on silver. It, therefore, continues to function as "an inconvertible note printed on silver."

Besides the rupee, other coins made of copper and silver are legal tender in India. These are one anna, two anna, and four anna pieces in nickel, and pice and pies in copper. Rupees and half rupees are full legal tender while other coins are legal tender upto one rupee.

It will be observed that the present position of the rupee is even worse than it was before the War. Upto 1915 the rupee was, at least in theory,

1 It was Rs. 9.48 crores in 1939-1940.



convertible into gold for exchange purposes but now its value depends on that of sterling which is no longer linked to gold. "It is neither fish nor fowl nor bright red herring. For sheer inexplicability, manipulative facility and complicated mechanism nothing approaching it has ever been invented.<sup>1</sup>

**Case for Devaluation.** The agitation in favour of 16d ratio apparently died with the vote of the Assembly in 1927 but was soon revived by the quick march of events all over the world. The prices fell slowly up to 1929 and rather abruptly thereafter as the following figures will show:—

Year	India (Calcutta)	United Kingdom.	United States of America.	Japan.
Average of				
1925	159	159	104	202
1926	148	148	100	179
1927	148	141	95	170
1928	145	140	97	171
1929	141	100	100	100
1930	116	88	91	82
1931	96	77	77	70
1932	91	75	68	73
1933	87	75	69	82
1934	89	77	79	81
1935	91	78	84	84
1936	92	83	85	90
1937	102	95	91	108
1938	98	93	84	113

This catastrophe was brought about by a variety of causes. Progress of mechanical inventions and of science in breeding new kinds of grains, seeds, cotton etc., unaccompanied by corresponding increase in consumption caused over-production. Post-war tariffs, quotas, financial restrictions, reparation payments etc., created a general feeling of insecurity and

<sup>1</sup> N. R. Sankar in a speech delivered before the Currency League of India on the 25th October, 1933, at Bombay.

panic. Most of the gold was concentrated in the hands of France and U.S.A. leading to serious curtailment of currency and fall of prices in other countries. But whatever the cause of this economic depression may have been, one thing is quite certain *viz.*, that it cut the purchasing power of the producers by half. Since the prices of agricultural produce fell more steeply than the prices of manufactured articles the agriculturists were obviously the worst sufferers much more so because interest charges and land revenue were inelastic. Many countries of the world sought to render necessary assistance to their producers by raising prices artificially. The following table gives an idea of the extent to which currencies of certain countries have depreciated after the War.

Country	Pre-War Parity £ 1=	Parity on Nov. 1, 1933 £ 1=	Present value of foreign currency expressed as a percentage of its pre-War value.
Belgium	25.207 Francs	111.40 Francs =22.48 Belgas	22.6 per cent
France	25.207 Francs	80 Francs	31.5 " "
Greece	25.207 Drachmae	555 Drachmae	4.5 " "
Italy	25.207 Lira	60 Lira	42.0 " "
Portugal	4 48 Esendos	103 Esendos	4.5 " "
Spain	15 207 Pesetas	37 Pesetas	68.0 " "

The relative depreciation of each of the above currencies is obvious but even the above table does not tell the full tale of the decline and fall of some of the more important countries with whom India comes in intimate contact. One such country is Japan. The Japanese Yen to-day is worth 50 per cent of what it was before the War. The pre-War parity of Yen was Yen 1=2s. 0 $\frac{9}{16}$ d. To-day Yen 1=1s. 2 $\frac{1}{2}$ d<sup>1</sup>. The case of India is quite

<sup>1</sup> The American dollar is only 90 per cent of its pre-War value. The currencies of Australia and Newzealand have depreciated by about 25 per cent and the currencies of Brazil, Argentina, Roumania etc., have depreciated beyond measure.

different. Forgetting the hectic days after the war when the rupee went up to 2s. 10d and the people and the Government sustained heavy losses, the broad fact remains that the rupee which was equal to 1s. 4d before the war is now equal to 1s. 6d. The £ which brought Rs. 15 before the war now brings only Rs. 13-5-4 or, in other words, the rupee is 112.5 per cent of its pre-War value in terms of the £. If, therefore, the history of world currencies is any guide, there does not seem to be much justification for hanging on to 1s. 6d in India which is perhaps the only country to face the depression with an appreciated currency. Lord Linlithgow, as chairman of the Royal Agricultural Commission, had said: "Raise the purchasing power of the *ryot* and help him to raise himself out of his present terribly depressed condition, and in one stroke you will give to industry, to manufacture and to commerce, an extended field for service, and so for legitimate gain." Unless His Excellency has since changed his mind he should put his weight on the side of 16d ratio.

Another interesting point borne out by a comparative study of index numbers is that, except in the two years (1924-26) to which the Hilton Young Commission referred as the basis of their recommendations in favour of the 18d ratio, the Indian and British index numbers have never moved together. In fact the adjustment between the two price levels is conspicuous by its absence. From 1929, the year of the commencement of the depression, Indian prices have been lowered by 43 points whereas British prices have suffered a fall of only 7 points. Moreover, while between September 1931 and March 1938 wholesale prices in England rose by 16 points, they increased in India only by 2 points. This proves conclusively that this country has not realised any thing like the benefits that were expected to be

reaped simply by linking the rupee with a depreciated sterling without lowering the ratio.

A careful study of trade statistics reveals that our trade balance has sunk very low. From Rs. 86.5 crores in 1928-29, it declined to Rs. 79 crores in 1929-30, to Rs. 62 crores in 1930-31, to Rs. 34.8 crores in 1931-32 and to the almost unprecedented low figure of Rs. 3.4 crores in 1932-33. It is true that both imports and exports have fallen in value but it cannot be denied that the influence of the existing ratio has been exercised in the direction of discouraging the export trade of the country in favour of the import trade. Taking the figures for 1925-26 as the base, the following are the index figures for the imports and exports of private merchandise :—

	1925-26.	1926-27.	1927-28.	1928-29.	1929-30.	1930-31.	1931-32.	1932-33.
Imports	100	102	111	112	107	73	56	60
Exports	100	80	85	88	63	60	42	35

Such a continued disparity between the movements of import and export trade indicates that the rate of exchange is acting definitely to the detriment of the producers of exportable commodities. It will further be observed that since 1930 while the Indian prices have undergone a precipitous fall Japanese prices have actually shown an upward tendency. The present Indian figure is 18 points below the 1930 level while the present Japanese prices have risen by 3 points during the same period. It means that the Indian producers are being forced to sell at less than pre-War prices goods which were produced at higher than the pre-War costs and to compete with Japan which has the further advantage of a depreciated exchange.

It is sometimes asserted that the lowering of the ratio would adversely affect the wage-earners, the salaried and professional classes and the public revenues. This is true to the extent that a scaling down of the ratio would be accompanied by a comparative rise in prices but the experience of the last few years has proved that low prices are not necessarily in the interest of people earning fixed incomes or even of the Government. If the price level is lowered not only the producing but also the wage-earning classes have to bear the evil consequences. If the producers are forced to market their goods at unremunerative prices they are compelled either to reduce wages or to give up business. In both cases the wage-earners suffer in the end, at least as much as the producers. The position of the professional and salaried classes is not essentially different. The demand for their services falls off and as the public or private employees experience a shrinkage in their revenues they have to resort to curtailment of staff and retrenchment of salaries. Even the Government of India are not in a very happy position. They may have made a little saving in the remittance of Home Charges but this gain has been more than offset by a substantial fall in revenue. A straitened peasantry, an unemployed and impoverished middle class, and a losing industrial and mercantile community are certainly not the best tax-payers. It has only amounted to killing the goose that lays the golden egg.

To the charge that the devaluation of the rupee will disturb the relation between creditors and debtors, it may be replied that at present the creditors are hardly receiving anything and if prices are raised they at least stand a chance of melting the frozen credits and getting some return for their money which they will cheerfully accept.

The plight to which the nation at large and particularly the agriculturists have been reduced during the last few years is too pitiable for words. There is an urgent need for raising prices if trade, industry and agriculture are to be saved from the present parlous state and for widening the channels of our export trade and so to increase the volume of our trade balance from which alone we can possibly meet our foreign obligations. It is, therefore, suggested that the Government should take early steps to restore the rupee to 1s. 4d parity.

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### SUMMARY

The Babington Smith Committee, appointed in 1919, recommended that sovereigns should be made legal tender in India, although no legal obligation should be imposed on the Government to convert token currency into gold. The exchange value of the rupee in terms of the sovereign was fixed at 2s gold which was then equivalent to about 3s sterling. The reasons for recommending a high rate of exchange were that the rupee would remain a token coin and the resulting low level of prices would benefit the people at large. Substantial saving in the remittance of Home Charges was also expected.

**Fate of 2s Rate.** Unfortunately for the Government, however, gold then was selling at a very much higher price than the one suggested by the Commission and no gold was tendered at the treasuries. Similarly, owing to unfavourable balance of trade and continued high level of prices, the exchange weakened considerably. The Government tried to ease the situation by selling Reverse Council Bills but they only tended to make confusion worse confounded. Money was withdrawn from Indian investments and exported to England to take advantage of the high rate of exchange. The 2s rate, therefore, broke down and the businessmen who had ordered goods in England in the hope that the exchange would remain at 2s suffered heavy losses because they were called upon to make payments when the exchange had fallen to below 1s. Between 1922-25, there was no legal standard, although the Government successfully attempted to maintain the value of the rupee in terms of the sterling at 1s. 6d.

**The Hilton Young Commission.** In 1926, the Indian currency system came under the searching examination of the Hilton Young Commission. The Commission suggested that the gold exchange standard was defective because it was difficult to understand. It did not provide automatic expansion and contraction of currency, necessitated the maintenance of unnecessary reserves and was looked upon with suspicion by the people. Some people supported the gold exchange standard on the ground that it was economical and particularly suited to India. They forgot that a system which locks up huge quantities of gold and silver without being used for industrial purposes and which is not easily intelligible to a lay man in the street cannot function satisfactorily for any length of time.

The Commission rejected the sterling exchange standard on the ground that, in addition to all the defects of the gold exchange standard, it suffers from the additional disadvantage of making the monetary standard of one country *dependent* on the currency and prices of another. They also disapproved of the idea of introducing a gold currency standard because it was "untimely, unsound, and impracticable." Finally, they recommended the Gold Bullion Standard according to which the rupees and notes were to cease to be convertible into each other and to be ultimately redeemable into gold bars of 400 ounces at all times and for all purposes at fixed rates calculated on the basis of the rupee being equal to 18s. The management of the system was to be entrusted to the Reserve Bank also suggested by them. Some people opposed the Gold Bullion Standard on the ground that the freedom to convert token currency into gold was nominal because few people could afford to purchase 400 ounces all at once. They also pointed out that in view of the fact that the notes would cease to be convertible into rupees, their position would become much worse than before the War. In all fairness to the Commission it must be confessed that the very fact of convertibility (no matter in what form it may be) acts as a safety valve against deliberate and unconscious inflation of currency. Again, paper notes redeemable in gold bars would inspire greater confidence than those convertible into silver rupees which are themselves inconvertible. The Gold Bullion Standard is also likely to economise the use of gold and encourage habits of banking and thrift. It is, therefore, not only superior to the gold exchange standard but quite as *effective* and *practical* as the gold currency standard.

**The Ratio Problem.** After 1923 the prices fell and the balance of trade became more favourable so much so that the rate of exchange touched rs. 4d in September 1924, rose to rs. 6d in May and remained firm at that for the next two years. The Hilton Young Commission, therefore, recommended that the rupee should be stabilised at rs. 6d.

**Arguments for 1s. 6d** Other arguments advanced in favour of 1s. 6d were:—

- (a) Indian prices were adjusted to world prices at rs. 6d, the price level in either country being 158.
- (b) Revision to rs. 4d would mean a rise of prices by 12½ per cent., and
- (c) In view of the fact that wages of industrial and agricultural labourers had been adjusted to rs. 6d, the lower ratio would bring about a concealed reduction in wages.
- (d) Similarly, most of the contracts were entered into when the exchange was rs. 6d and any lowering of the ratio would result in heavy losses to the creditors.
- (e) The burden of the agriculturists in respect of land revenue would increase but this loss had already been made up by the high prices of agricultural products since the War.

**Arguments for 1s. 4d.**

- (a) The adjustment between Indian and world prices was not complete.
- (b) 1s. 4d was a natural and a *de facto* rate while rs. 6d was brought about artificially by contracting currency.
- (c) 1s 6d by lowering prices, pressed heavily on the manufacturers and conferred an unfair advantage on the foreign producers.
- (d) The agriculturists stood to lose heavily for, while the prices of their products declined, their burden in respect of land revenue increased enormously.



- (e) *Is. 4d* may be harmful to the wage-earners but even their loss may be minimised by the continuity of employment which may be difficult if the manufacturers sustained heavy losses following the adoption of a higher ratio.

**Conclusion.** Much could be said on either side. In view of the fact that *stable* prices are always preferable to rising or falling prices, *Is. 6d* rate seemed to be more justified than *Is. 4d*. But, as the country, in the long run, is likely to benefit more by *Is. 4d*, it is suggested that the Government should expand currency gradually so as to be able to stabilise exchange at *Is. 4d* at the earliest possible opportunity.

**The Act of 1927.** According to the Act of 1927, the Government were bound to purchase gold in amounts of not less than 1,065 tolas at rates based on the *18d* value of the rupee.

The Act was, however, suspended in September, 1931, when England abandoned the gold standard. The present currency system of India is called the Sterling Exchange Standard. For internal purposes the rupee, as before, is the standard of value, while for external purposes the Government have undertaken to convert notes and rupees into British sterling at *Is. 6d*. The rupee, therefore, continues to be a standard token coin and still resembles an inconvertible note in all respects except that while the former is printed on silver, the latter is printed on paper.

**Case for De-valuation.** On account of recent slump in prices the producers, particularly the agriculturists, have suffered a good deal. Other countries have tried to alleviate the distress of their producers by giving them larger purchasing power. India should do the same by reverting to *Is. 4d*. Since England abandoned the gold standard, British and Indian prices have not moved together. No useful purpose will, therefore, be served by being tied to the apron strings of sterling. *Is. 4d* will not only help the trade and commerce of the country but it would also give immense relief to people earning fixed incomes by providing employment. The Government are almost certain to gain more from enhanced revenues than they are likely to lose in Home remittances. Hence, a strong case has been made out for a depreciation in the value of the rupee, at least to bring it to its pre-War relation with the Pound Sterling.

## QUESTIONS

1. Why did the Babington Smith Committee recommend the 2s. rate? What was the fate of that ratio?

2. Discuss the strong and the weak points of the Gold Exchange Standard as it prevailed in India before the War.

[Delhi Inter. 1929 and 1930; Punjab B.A. 1928].

3. Distinguish between the Gold Exchange Standard and the Gold Bullion Standard proposed by the Hilton Young Committee. State your views on the latter as a scheme of currency arrangement for the country.

[Punjab B.A. 1928 and Delhi Inter. 1930].

4. Examine the case of 18d exchange value of the rupee as against 16d exchange value.

[Delhi Inter. and B.A. 1931; Agra B.A. 1935].

5. (a) What is the effect of a rate of exchange on price-level? Give Indian examples.

(b) How do changes in the value of money affect different classes of people in a country?

6. Explain as simply as you can the recent changes in the monetary standard of India.

[Delhi Inter. 1933].

7. Account for the unusual export of gold from India at the present time. Has India benefited by it?

8. Describe briefly the currency system that is in vogue in India at the present time and explain the measures that are taken by the Government of India to maintain stability in the value of Indian currency in terms of foreign currencies.

[Agra B.A. 1934 and Punjab B.A. 1934].

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## CHAPTER XIII

### THE INDIAN CURRENCY SYSTEM (*Continued*)

SINCE SEPTEMBER 3, 1939.

Great Britain got involved in the present war on September 3, 1939 to defend the fundamental right of nations to a free and peaceful existence and to uphold the sanctity of international agreements. She had the moral support of all the civilised nations of the world but their lip sympathy alone could not help her to win the war nor could the resources of Great Britain alone annihilate an enemy who had been preparing for protracted hostilities for a long time. The war called for enormous sacrifices on the part of the countries constituting the British Empire, and necessitated vital changes in their economic organisation. Let us see how it has affected the currency and prices in India.

**Withdrawal of Bank Deposits.** As during the last Great War, the first instinct of the people at the out-break of hostilities was to sell their Government securities, encash Post Office Cash Certificates<sup>1</sup> and withdraw their deposits from the banks including Postal Savings Banks<sup>2</sup>. This tendency

#### 1 Post Office Cash Certificates

	Lakhs outstanding at close of year.
1938-39	59.57
1939-40 (Budget)	59.69
1939-40 (Revised)	56.93
1940-41 (Budget)	55.41

2 How serious was the panicky withdrawals from postal savings banks may be gathered from the increased provision in the budget for net repayments of Post Office Cash Certificates from Rs. 1½ crores to Rs. 10 crores and a net outgo of Rs. 19 crores under Postal Savings Banks<sup>3</sup> Deposits in 1941.

The situation created by the withdrawal of deposits from Post Offices has been successfully tackled and it may now be definitely stated that the run as such has died out and that a good portion of the funds is finding its way into the postal saving banks.

became widespread soon after the enactment of the Emergency Powers (Defence) Bill by the Government of the United Kingdom because rumours were current that the Government of India contemplated drastic measures for the control and confiscation of private wealth and property. The Government immediately and emphatically contradicted these rumours and the public confidence was soon restored. This is borne out by a close scrutiny of the position of the scheduled banks as disclosed in their weekly returns : —

	Demand Liabilities. (In lakhs of Rs.)		Time Liabilities. (In lakhs of Rs.)	
	Amount	Increase or decrease.	Amount	Increase or decrease.
August, 25, 1939	142,58	...	106,87	...
September, 29, "	139,21	- 3,37	102,11	- 4,76
October, 27, "	140,82	+1,61	99,76	- 2,35
November, 24, "	145,04	+4,22	101,81	+2,05
December, 29, "	146,57	+1,53	104,76	+2,95
January, 26, 1940	146,43	- 14	107,89	+3,13
February, 23, "	145,10	- 1,33	109,09	+1,20
March, 29, "	150,38	+5,28	108,08	- 1,01
April, 26, "	147,66	- 2,72	113,08	+5,00
May, 31, "	145,43	- 2,23	112,14	- 94
June, 7, "	144,31	- 1,12	111,46	- 68
July, 19, "	151,37	+7,06	106,83	- 4,63
August, 16, "	157,35	+5,98	104,02	- 2,81
September, 13, "	163,57	+6,22	101,11	- 2,91
October, 18, "	170,50	+6,93	100,38	- 73
November, 15, "	175,31	+4,81	100,34	- 4
December, 20, "	175,46	+ 15	101,03	+ 69
January, 10, 1941	177,80	+1,34	100,92	- 11
February, 14, "	177,83	+ 3	104,10	+3,18
March, 14, "	179,87	+2,04	105,21	+1,11
April, 18, "	184,44	+4,57	105,09	- 12
May, 16, "	185,71	+1,27	106,40	+ 31
		+42,13		- 1,47

It will be noticed that there have been withdrawals from banks but they are no more than what the sheer instinct of precaution (which is far removed from panic) would justify. Moreover, although the rush for withdrawals was great in the

beginning, the withdrawals during May 1940, which was a critical month, were less than in the first month of the War. It is also clear that inspite of frequent withdrawals the current accounts of scheduled banks since the War began have risen by more than Rs. 42 crores although the total deposits have increased by Rs. 40.66 crores only.

**Rush for Conversion of Notes. Rationing of Rupees.** There was also a great demand for the conversion of notes. Prior to June, 1940, this demand was sporadic and averaged less than a crore of rupees per week, but with the collapse of France in that month the total value of notes presented for encashment suddenly rose to Rs. 4 crores a week. There was thus a great strain on the rupee resources of the Reserve Bank. The demand for rupees further increased on account of the Government's increased expenditure on armament and defence and also on account of the increased business activity stimulated by the War. The Reserve Bank at first met this demand in full in the hope that such action would allay the fears of "panic-mongers" and check hoarding of rupees but the result was disappointing. Rs. 42 crores of rupee coins were issued in the first ten months—Rs. 13 crores having been put into circulation in June alone—but still there was chronic shortage. When the Government realised that meeting the public demand for rupee coins without limit did not relieve the strain and prevent the absorption of rupee coins, they were forced to resort to the system of rationing under which the issue of rupees by the Reserve Bank to single tenderers was limited to normal legitimate requirements and the acquisition of rupees in excess of personal or business requirements was made punishable under the Defence of India Act. It was pointed out that the introduction of rationing was necessitated not by

the shortage of silver but only by the mechanical limitations of the mints which were unable to mint coins in sufficient quantities and at sufficient speed to cope with the abnormal demand.

**Issue of One-rupee Notes.** As a result of large withdrawals of rupee coins from circulation much inconvenience was felt by the general public owing to the scarcity of a suitable medium of exchange of smaller value than the Reserve Bank notes of the lowest denomination, namely Rs. 5. The Government, therefore, decided to supplement the stock of rupee coin by one-rupee notes issued on the authority of the Government of India. An Ordinance (No. IV of 1940) was accordingly issued on June 24, 1940 authorising such issue and providing that such notes will for all purposes be the equivalent of rupee coin. They are legal tender to exactly the same extent as rupee coin and, not being bank notes or currency notes, can be issued by the Reserve Bank in exchange for their bank notes to satisfy the demand for rupee coin. As the new notes could not be manufactured and put into circulation immediately, the Government made use of one-rupee notes which had already been printed in 1935 to meet a contingency of another nature.<sup>1</sup> These 1935 notes are printed on paper bearing as a water mark the head of His Late Majesty King George V and are  $3\frac{3}{8}$ -inches by

1 The circumstances which led to the preparation of one-rupee notes in 1935 were as follows:—

After the last war the price of silver fell very low and touched the rock-bottom level of 13·25d per oz. (about 5 annas per tola) in 1931. In 1934, the countries interested in silver entered into a Four-year Agreement under which the Indian Government promised to sell not more than 35 million ounces of silver per year while the Governments of the U. S. A., Australia, Canada, Mexico and Peru promised to purchase an equivalent amount. The U. S. A. went a step further in 1935. They undertook to buy silver until the silver stocks constituted 25 per

(Continued on page 196)

$2\frac{1}{8}$ -inches in size. They contain a representation of the rupee coin on both sides and bear the signature of Mr. J. W. Kelly who was Controller of Currency in 1935. The new notes which are being printed at the Government of India Security Printing Press, Nasik will be 4-inches by  $2\frac{1}{2}$ -inches and the design, colour scheme and water-mark will also be different. They will bear the signature of Mr. C. E. Jones, Secretary to the Government of India in the Finance Department.<sup>1</sup>

**New Eight-anna Pieces.** In view of the increasing simultaneous demand for four-anna pieces and half-rupees, the Government of India felt that it would be extremely wasteful to turn out large quantities of half-rupees containing eleven-twelfths of silver and one-twelfth of alloy. They, therefore, decided that the fineness of one-half silver and one-half alloy prescribed for four-anna pieces in the Act passed by the Central Legislature should be adopted for eight-anna pieces as well. Ordinance No. VI of 1940 was accordingly promulgated to amend the Indian Coinage Act for this purpose.

1 It may be interesting to note in this connection that the wear and tear of a rupee note is very much greater than that of a silver rupee. The average abrasion of a rupee is 15 per cent in fifty years whereas the average life of a rupee note is only six months. This is the reason why the Incheape Committee recommended the withdrawal of one-rupee notes from circulation.

*(Continued from page 195)*

cent of their metallic reserves and until the price of silver touched 64d per oz. i.e. about Rs. 1/8/- per tola. The result of such a policy, if consistently followed, would have been dangerous for silver using countries. The U. S. A. commenced operations immediately after the Act was passed and in April, 1935 the price of silver rose to 36·25d per oz. making the bullion value dangerously near its face value. As a direct result of this rise in the price of silver, China had to give up the silver standard and the Indian Government, in order to forestall an emergency, printed a large quantity of one-rupee notes. The anticipated danger, however, did not materialise on account of the reversal of the silver purchase policy of the U. S. A. and the price of silver receded back to the low level of 20d in 1936 and remained between 16d and 19d during 1936-39. The occasion for putting the new notes in circulation, therefore, did not arise.

New half-rupees of the reduced fineness are exactly similar in weight and appearance to the old half-rupees but the ring is somewhat sharper. Half-rupees of the old fineness will no longer be minted but will continue to be legal tender.

**Queen Victoria Rupees. Withdrawn from Circulation.** The Government had under consideration, even before the War, the question of withdrawing Victoria rupees and half-rupees. They were unpopular owing to the large number of counterfeits in existence which were difficult to detect owing to the worn condition of the coins. In view of the unsuitability of the coins as a media of currency and in order to recover them from the useless hoards, the Government decided to call them back. An Ordinance was promulgated on October 11, 1940 amending the Indian Coinage Act and by a Notification issued under the Act as amended, it was declared that Victoria rupees and half-rupees shall cease to be legal tender after March 31, 1941 but shall continue to be acceptable until September 30, 1941 at all Government Treasuries and Post Offices and thereafter, until further notice, only at the offices of the Issue Department of the Reserve Bank at Bombay and Calcutta.

**New Rupee Coins.** By an Ordinance issued on December 22, 1940 the Government have been authorised to issue silver rupees of the fineness of one-half of silver and one-half of alloy *i.e.* containing 90 grains of pure silver and 90 grains of baser metals. These new rupees contain a "security edge device" which is considered to be a complete safeguard against counterfeiting. For over a century the people of India have been used to rupees weighing one tola and containing 165 grains of pure silver and the present issue



containing a much smaller percentage of silver is being accepted by them not without considerable suspicion and misgivings. Moreover, there are, at the present moment, three different forms of one-rupee units in circulation—the old 22-carat silver rupees, the new 12-carat silver rupees, and one-rupee notes. They will circulate only so long as the demand for money is great but if confidence is somehow shaken the old rupees are bound to go back into the hoards<sup>1</sup>.

**A New Mint for Calcutta.** Owing to the increased demand for coinage caused by the War, a heavy strain has been put on the mints at Bombay and Calcutta and the extension of plant capacity became necessary. The Government have accordingly decided to construct a new mint at Calcutta at a cost of about Rs. 65 lakhs. This mint will have a normal capacity of Rs. 6 lakhs per day or approximately double the present output when the mint is working full overtime. It is proposed to close down the old mint when the situation returns to normal and to extend the new mint for the production of nickel, bronze, and silver coins as well.

**Increase in the Volume of Circulating Media.** Active note circulation in India and Burma on September 1, 1939 was Rs. 178·88 crores and had risen to Rs. 273·11 crores by May 23, 1941. The increase in active paper note circulation was thus Rs. 94·23 crores. In the same period, 'rupee coin' held in the Issue Department of the Reserve Bank had declined from Rs. 75·87 crores to Rs. 35·89 crores. Making allowance for the fact that during this period the Government had delivered coins to the Reserve Bank to the extent of Rs. 10 crores this means that the circulation

<sup>1</sup> Due to the operation of Gresham's Law.

of rupee coins has risen by Rs. 39·98 crores since the beginning of the War. The total increase in the volume of currency in circulation between September 1939 and May 1941 is thus Rs. 134·21 crores<sup>1</sup>. There has also been a considerable increase in the volume of circulation of subsidiary coins. It would, therefore, not be wrong to say that the volume of currency in circulation today is higher by about Rs. 150 crores than it was on September 1, 1939.

A careful analysis of the balance-sheet of the Reserve Bank for the week ended May 23, 1941 will show that the position of India's currency is quite sound. The assets of the Bank in the Issue Department in gold coin, gold bullion and sterling securities was 55·43 per cent of its total

<sup>1</sup> The following table indicates the position both as regards paper notes and rupee coin upto December 1940:—

Month	Increase or Decrease in circulation as on last Friday of the month (in lakhs of rupees).	
	Note circulation	Rupee coin circulation.
September 1939	+ 24·03	+ 33
October "	+ 7·38	+ 2·60
November "	+ 9·81	+ 3·04
December "	+ 15·81	+ 5·28
TOTAL	57·03	11·25
January 1940	+ 1·92	+ 3·37
February "	+ 1·71	+ 2·56
March "	- 1·00	+ 2·35
April "	+ 1·06	+ 2·56
May "	+ 8·92	+ 6·81
June "	- 1·59	+ 15·12
July "	- 9·02	+ 5·18
August "	- 6·43	+ 3·62
September "	- 2·31	+ 2·03
October "	- 51	+ 1·00
November "	+ 48	+ 83
December "	+ 12·09	+ 1·13
TOTAL	5·32	44·56

liabilities or more than 15 per cent higher than the conservative limit of 40 per cent fixed by the Reserve Bank of India Act<sup>1</sup>. Every paper note is, as we shall see presently<sup>2</sup>, fully backed by either gold, or easily realisable sterling, silver rupees or the obligations of the Government of India which are realisable at a moment's notice. There are definite indications that the panicky demand for coins is now a thing of the past; that more or less complete confidence has been restored in this respect; that one-rupee notes are circulating freely not only in the cities and towns but also in the rural areas; and that the coins are slowly but surely coming back from the hoards.

**Balance of Trade. Restrictions on Imports and Exports.** Indian exports of merchandise to foreign countries increased from Rs. 163 crores in 1938-39 to Rs. 203 crores in 1939-40 i.e. by about Rs. 40 crores in value during the first year of the War.<sup>3</sup> On the other hand, the imports of commodities into British India has been kept down by means of import restrictions imposed in May 1940.<sup>4</sup> The articles affected are those the consumption of which can be kept within limits without damage to any essential Indian interest (having regard, in particular, to the extent to which supplies from some

1 Comparatively speaking, there has been a good deal of deterioration in the reserve position during the last 12 months. The percentage of assets to liabilities during this period has fallen from 65.33 to 55.43 i.e. by about 10 per cent.

2 Chapter XIV.

3 The notable increase in the absorption of Indian exports occurred in the case of the United Kingdom and the British Empire. These countries increased their purchase of Indian goods from Rs. 85 crores in 1938-39 to Rs. 113 crores in 1939-40. The United States of America increased the purchases from Rs. 14 crores to Rs. 24 crores during the same period.

4 The imports actually increased at first i.e. from Rs. 152 crores in 1938-39 to Rs. 165 crores in 1939-40, but owing to the closing of foreign markets and difficulties of transport they are now showing a downward tendency.

countries can be replaced by Indian products or by goods imported from other countries in respect of which the foreign exchange problem is less acute). Export restrictions have been devised not only to prevent supplies from reaching the enemy by indirect channels, but also to conserve supplies of all essential articles, whether for the requirements of India or for those of the Allied countries. Among the articles the exports of which have been restricted mainly for conservation of supplies, raw wool and mica deserve special mention.

**Exchange Control Restrictions.** Following the example of Great Britain, the Government of India have also undertaken to control exchange. Part XIV of the Defence of India Ordinance, 1939 contains financial provisions, providing *inter alia* for (i) restrictions on purchases of foreign exchange, (ii) acquisition by the Central Government of foreign exchange, (iii) restrictions on purchases and export of securities, and (iv) acquisition by the Central Government of foreign securities. All foreign exchange transactions were required to be put through authorised dealers controlled by the Reserve Bank; restrictions were placed on the purchase and sale of Empire currencies while the sale and purchase of non-Empire currencies were restricted to genuine trade purposes, travelling expenses and small personal remittances.

As a large amount of the essential war material has had to be purchased from America, including motor transport for the mechanisation of the Indian Army, it has been particularly necessary to conserve all dollar resources for Commonwealth needs. For this purpose dollar balances have been taken over by the Reserve Bank, remittances to the United States or Canada have been banned,

imports of luxury goods from outside the sterling area have been restricted to the minimum, imports of silver have been forbidden except under licence, and dollar exchange granted only to persons travelling abroad in the national interest.

The policy of the Reserve Bank of India has been to ensure that all transactions were put through on the basis of the rates fixed by the London Exchange Control. In the early stages of the Control it was possible for the American importers of Indian goods to evade the regulations. The creation of a free sterling market in America no doubt resulted in some loss to the Indian exporters but with the tightening of the Control the rates have become more efficient<sup>1</sup>.

Owing to the difficulty of obtaining cover in London for positions other than spot, forward exchange business on the part of banks was paralysed. The Reserve Bank, therefore, announced on October 3, 1939 that it would be prepared in future to purchase sterling for forward delivery extending over a period of 90 days at  $\frac{1}{32}$ d per month higher than its spot buying rate. This innovation is unique in the currency history of India. In February 1940, the Reserve Bank decided to buy sterling at 1s. 6d upto 6 months forward. On October 16, 1940 the Bank announced that the exporters of gold from India to U.S.A. must surrender at least 34 dollars for each fine ounce of gold exported. It also announced its

1 In order to understand the difference between "official" and "free" sterling, the advanced student is advised to read "*Review of Trade in India*" for 1939-40 and 1940-1 and an excellent article—*India and the Two Sterlings*—in the July number of the Indian Institute of Bankers.

readiness to buy dollars for spot delivery. On the 9th March 1940, the Bank also announced its scheme for the control of the foreign exchange proceeds of certain exports to the 'hard currency' countries *i.e.* countries having currencies based on gold (like the U. S. A. dollar and the Swiss franc) or linked to currencies which are based on gold. The commodities affected were jute, jute manufactures and rubber. The object of the scheme is to obtain control of the foreign currency proceeds of the exports and also to see that full export proceeds (based on the official rate of dollar-sterling exchange) of the goods are received.<sup>1</sup>

**Repatriation of Sterling Debt.** As a result of a very favourable balance of trade, a large sterling balance accumulated in the hands of the Reserve Bank. This surplus has been used for the repatriation of the sterling debt of the Government of India. Two methods have been adopted for the repatriation of sterling. Under one method, the Reserve Bank was authorised to purchase Indian sterling non-terminable securities in the open market out of its surplus sterling balances and to transfer the securities so purchased to the Government for cancellation. In their place additional rupee paper of the  $\frac{1}{2}$  per cent and 3 per cent non-terminable loans was to be created from time to time. Another method was to offer the holders of all sterling loans the option of converting their holdings into rupee securities.

<sup>1</sup> The combined effect of these measures adopted by the Government for the control of exchange has been to keep the exchange pegged at 1s. 6d. A disruption of the sterling-rupee rate was, however, threatened on the 31st March, 1941. Owing to the continued difficulty of securing shipping space, export bills were few and far between. On the other hand, private remittances were on a fairly substantial scale. In other words, there were abundant buyers of sterling and very few sellers of sterling and it appeared as though from want of cover the rupee rate would break down. The Reserve Bank, however, prevented the exchange from deteriorating by offering to sell Reverse Council Bills at 1s. 5 $\frac{31}{32}$ d.

The combined use of the two methods enabled the Government to effectively repatriate more sterling debt than would have been otherwise possible. By these means the Government have brought about an appreciable substitution of sterling liabilities to non-residents by rupee liabilities to residents which have provided a valuable relief to their remittance programme. India's sterling debt and the amount of interest to be paid abroad each year have also been substantially reduced.<sup>1</sup>

**Additional Taxation.** To pay for the expansion and mechanisation of the Indian Army, which has been estimated to cost Rs. 20 lakhs per day, additional taxes were imposed in November 1940 and March 1941. The Supplementary Finance Bill of 1940 imposed a 25 per cent sur-charge on all taxes on income and increased letter postage, telegram and telephone charges while the budget of 1941 increased the Excess Profits Tax and imposed an extra duty of Re. 1 per cwt. on sugar and of two annas per gallon on petrol.

**Defence Loans** Unable to make their two ends meet, the Government of India floated Defence Loans on June 4, 1940. These loans consist of 3 per cent Defence Bonds, Defence Savings Certificates, and a three-year Interest-Free Loan. The 3 Per Cent Defence Bonds have met with a good

<sup>1</sup> The accumulation of huge sterling balance in London has proved extremely useful to Great Britain also. "It has played its part in contributing to the restoration of cheap money. .... It has helped to swell the volume of funds seeking reinvestment in the long term market, and has thus assisted in maintaining the level of gilt-edged values. Finally, it has produced a considerable supply of funds for direct investment in Government securities of various forms and has thus eased the task of bridging the gap between revenue and expenditure without recourse to inflationary borrowing". *Economist*.

In simple terms, India has contributed to three important features of the London Market, namely, (a) maintenance of cheap money; (b) maintenance of gilt-edged prices; and (c) facilitating the success of defence loans.

reception, the total amount subscribed upto November 30, 1940 being over Rs. 30 crores, of which Rs. 17 crores were subscribed in cash and Rs. 13 crores in conversions. The total subscription to the 10-year Savings Certificates totalled more than Rs. 1½ crores on the same date. The most recent development is the introduction of the Defence Savings Stamps of Re. 1, eight annas and four annas and of cards to which stamps are to be affixed to facilitate the collection of small subscriptions.

**Price Movements.** All the developments referred to above viz: increase of currency and credit, fresh taxation and Government borrowing, have tended to have inflationary effects but on account of a corresponding increase of commercial and industrial activity, prices have not risen much. Moreover, as in the last War, the Government have not left prices to be determined by the buyers and sellers themselves. We shall first trace the course of prices in India during the present War and then explain the measures adopted by the Government for controlling them.

The first four months of the War witnessed great activity in almost all the branches of national economy. The demand for raw materials was unprecedented and the prices shot up as the following figures will show :—

		Calcutta	Bombay	Karachi
August	1939	100	103	104
December	1939	137 <sup>1</sup>	135	121

Various reasons were attributed to this sudden

1 The rise was very un-even as the following figures will show :—

137—General index of primary commodities.

142—Index of manufactured articles.

125— " " food and tobacco.

184— " " other agricultural products.

130— " " raw materials.



rise of prices. Some held that the rise in the prices of essential commodities like jute and cotton, and perhaps silver, was the direct cause of the rise in the prices of all agricultural products, while others maintained that a rise in the prices of agricultural products like wheat and cereals, caused by unseasonable rainfall, helped to bring about a rise in the prices of other commodities. The more reasonable explanation, however, seems to be that the war created an abnormal demand for many commodities which was stimulated by their prospective shortage. A vicious circle set in, in the form of rising prices and increased hoarding of consumers' stocks, and the sellers exploited the situation to their advantage. In other words, the rise of prices in many cases was due to *speculation* and *profiteering*, except perhaps in the case of imported articles the higher prices of which could be accounted for, to some extent, by higher freight and insurance charges.

The rising prices stimulated production. Exports increased and there were signs of plenty and prosperity among the masses. But in January 1940 there was a pause. Prices ceased to advance and in fact certain commodities registered mild decline e.g. jute, cotton and linseed. In February there was a sharp set-back to which the Extra Profits Tax and the bogey of price control contributed. But it was anticipated that recovery was only a question of time and that it was bound to come. But in March and April prices fell still further owing to export restrictions.<sup>1</sup> In September the prices looked up again for the first time. The improvement did not extend to all commodities and

1 For a war period commodity markets were at low levels. Jute fell to Rs. 65 a bale compared with Rs. 125 per bale as in December, 1939, cotton to Rs. 263 per candy from Rs. 333 per candy, linseed to Rs. 7-8-0 per maund from Rs. 10 per maund. The general index number fell from 130 in January 1940 to 121 in April, 1940.

in fact in certain cases the prices still showed a downward tendency but the all-commodities index number increased to 121 in October 1940. In the case of precious metals, on the contrary, the prices showed a persistent rise. Gold touched a new high rate at Rs. 47-15-0 per tola and there was such a great demand for sovereigns that their prices were even quoted at 5 per cent more than their bullion value.

**Price Control.** The Government received many reports to the effect that prices of many common necessities of life had gone up considerably. The rise was particularly sharp in the case of imported articles like chemicals, patent medicines, tinned provisions, toilet requisites, etc., while commodities like meat, grain and sugar which are produced locally also recorded substantial increases. There was nothing to justify the rise of prices in many cases. Stocks of commodities were normal, export was not permitted except under licence and internal transport conditions were satisfactory. The Defence of India Ordinance, 1939 and the Defence of India Rules drawn up thereunder had empowered the Central Government to make provision "for controlling the prices at which articles or things of any description what-so-ever may be sold." The Government were also authorised to delegate these powers to the Provincial Governments if desired. The Provincial Governments were, accordingly, authorised (under Notification dated 8th September 1939) to fix limits to the extent of the rise of prices at each stage of the productive and distributive process, in the case of necessities and in particular of medical supplies, foodstuffs, salt, kerosene oil and the cheaper qualities of cotton cloth. The minimum price in each case was not to be less than ten per cent above

the prices ruling on September 1, 1939.<sup>1</sup> All the Provincial Governments took immediate action for controlling prices. The major lines of action are similar in all cases although minor details of procedure and administration have varied as between individual provinces.

Almost all Provinces appointed Controllers of Prices at Headquarters and empowered Deputy Commissioners and Collectors in charge of Districts to act as local controllers in respect of the areas within their jurisdiction. Both the Provincial and the District Controllers were to be assisted by Advisory Boards of Price Control Committees whose composition varied according to whether it was a Provincial or a District body. For the Provincial Committees, persons representing the interests of the agriculturists and industrial workers were also included. The function of these Committees was to advise the Controllers on price control, to keep Government in touch with the trend of trade and the difficulties experienced by traders and manufacturers and generally to keep Government in touch with the situation as it developed locally. Both prior to and after the appointment of these Committees, comprehensive press notes were issued noting the commodities the prices of which were to be controlled and warning dealers that any body charging higher prices would be prosecuted. Hoarding or refusing to sell was also to be punished. Purchasers were advised to demand bills for all articles bought and in cases where it was felt that

<sup>1</sup> The general principles underlying this policy were contained in a Memorandum prepared by Dr. Gregory, our Economic Advisor. No increase of price was to be permitted unless it was justified by increased cost. In other words, increase of price caused by intensification of demand or shortage of supply or communication was to be prohibited except in the case of agricultural staples of our export trade whose price was not to be controlled. In the case of war materials, the position of the Government as by far the most important customer, will lead to a process of bargaining which obviated the need for control.

excessive prices were being charged, to report the same to the police.

→ The Government of India also convened two Conferences of the representatives of all Provincial Governments and Administrations in India to discuss questions connected with price control. At the first of these Conferences held in Delhi in October 1939, the view was largely held that, so far as agricultural produce was concerned, it was undesirable to check the rise in prices, at any rate at that time. At the second Conference, which was held in January, 1940, one of the conclusions reached was that in all places where effective control had been established there had been a tendency for supplies to dry up or to go underground and for normal business to be dislocated and it was decided that it would be unfair when the agriculturist was making some little profit to put the screw on him and fix an upper limit for the prices of commodities. This Conference also agreed to the desirability of the Central Government taking in hand the work of coordinating price control policy of the Provinces. It was decided that at the stage of production and with reference to the wholesale markets of some of the principal commodities, the Government of India should be the proper authority for limiting, should occasion arise, the price of such commodities and that at the retail stage the Provincial and State units should have complete freedom to fix maximum prices, such maxima being fixed on the basis of the wholesale prices fixed by the Government of India.

→ It was realised at an early stage that world prices of foodstuffs would rise rapidly and that this would have its repercussions everywhere. Nevertheless, the Government of India were determined not to interfere with the prices of agricultural

produce because it was felt that such interference would deprive the cultivator of a golden opportunity to recover from the effects of the economic depression. It was also argued that the prices ruling before December 1939 were not really fair prices. The case of manufactured articles, however, was slightly different. Imported articles of general consumption are few viz: cotton goods, kerosene and medicines, and their prices could be easily regulated. Hence the attempts of the Government have been largely concentrated on imported articles of general use.

This policy has, however, not proved very effective and people have had to pay more for almost every article which is consumed now, although it must be admitted that the rise in many cases is small and is nothing as compared to the rise of prices experienced during the last War.

**Conclusion.** From the foregoing survey it will be seen that the Indian monetary system has stood the strain of the war remarkably well. After the inevitable dislocation in the first few weeks of the War, the system has quickly adjusted itself to the changed conditions and has withstood the worst shocks of the War. The transition from a peace economy to a war economy was effected in a much shorter time and with considerably less dislocation than during the last War. Every day the War is coming nearer to India and the rate of defence expenditure is increasing rapidly. The strain it will put on the Indian financial system will indeed be severe, but the history of the last twenty months proves beyond doubt that it will emerge with its strength unimpaired.

## SUMMARY

The War had profound effects on the currency and prices in India. In the beginning there was panic leading people to withdraw their deposits from banks and to present their notes for encashment but confidence was soon restored. But the hoarders of rupee coins presented serious difficulties especially at a time when the demand for currency had so enormously increased and the Government were forced to ration the issue of rupee coins.

In order to meet the increasing demand for money, the Government put into circulation one-rupee notes and new 4-anna, 8-anna and one-rupee coins—the coins containing a larger percentage of baser metals than before. The old Queen Victoria rupees were withdrawn and the silver thus obtained was used for manufacturing new coins. By these means the Government were able to expand currency to the extent of about Rs. 150 crores between September 1939 and May 1941.

➤ On account of the peculiar conditions created by the War, the balance of trade became favourable. Some import and export restrictions also became necessary—the former to prevent the import of luxury goods and the latter to conserve the supplies of all essential commodities for the Allied countries.

The Government also thought it necessary to control all dealings in exchange. As U. S. A. was the largest creditor country, the Reserve Bank adopted several measures to ensure a regular remittance of money to that country and private remittance was entirely prohibited.

As a result of a very favourable balance of trade a large sterling balance accumulated in the hands of the Reserve Bank. The opportunity was utilised for paying back a large part of our national debt and for converting sterling loans into rupee loans. The War also necessitated additional taxation and fresh loans.

The effects of all the measures described above would have been to raise prices. In fact during the first four months of the War the prices did rise by about 37 per cent. but by enforcing a reasonable and well-thought-out policy of price-control the Government have prevented the prices of most commodities from rising 10 to 20 per cent above the levels ruling before September, 1939.

### QUESTIONS

1. How has the currency system of India been affected by the present War. What steps have been taken to cope with the difficulties experienced in the management of currency and exchange since September 1939 ?

[Agia. B. Com. 1941]

2. Trace the course of prices in India since September 1939 and explain the steps taken by the Government for controlling prices.

3 Write notes on :—

(i) Exchange Control—(See Chapter VIII, pages 114-117)

(ii) Repatriation of Sterling.

## CHAPTER XIV

### HISTORY OF THE INDIAN PAPER CURRENCY SYSTEM

**Before 1861.** The paper notes are said to have existed in China in 800 A. D. and to have been adopted for use in Europe in the 17th century when the State Bank of Sweden issued them, for the first time, in 1656. They were practically unknown in India until the beginning of the nineteenth century when the foundation of the first Presidency Bank—the Bank of Bengal—was laid in 1806 to be followed by the Bank of Bombay in 1840 and the Bank of Madras in 1843.<sup>1</sup> Although these banks were purely private institutions, the Government liberally subscribed to their shares in lieu whereof they were allowed sufficient representation on their management. All the three of them enjoyed the privilege of note-issue, but the maximum amount to which each could issue notes was fixed<sup>2</sup> (the limit in the case of the Bank of Bengal being Rs. 2 crores) and they had to keep  $33\frac{1}{2}$  per cent specie in reserve which was subsequently reduced to 25 per cent. These notes were not legal tender in any part of the country and quite frequently the Government refused to accept them. Their popularity was restricted to the presidency towns of Calcutta, Bombay and Madras, and the total amount of notes in circulation

1 Between 1770 and 1861 there were about 35 banks, 10 of which, including the three Presidency Banks, were allowed to issue notes. The issue of some are said to have been very satisfactory. B. B. Das Gupta—*Paper Currency in India*—pp. 5-6.

2 This did not hamper the growth of note circulation as some people have imagined because whereas the Presidency Banks were allowed *together* to issue notes upto Rs. 5 crores they had seldom issued more than Rs. 2 crores. The non-Presidency Banks were even free from these restrictions.



was very small compared to the size and population of the country. The denominations of the notes issued varied from bank to bank and "even the definition of a bank note was not universally agreed upon."<sup>1</sup>

**1861-1914.** After great hesitation, the Government of India decided to establish their own monopoly of note-issue in 1861.<sup>2</sup> Act No. XIX of that year deprived the Presidency Banks of the right of issuing notes and created a Paper Currency Department through which the Government were to issue notes of various denominations in the form of promissory notes payable on demand. The country was divided into three circles of issue *viz.*, Calcutta, Madras and Bombay and notes issued from any of these circles were not legally encashable outside their respective areas. Later, as paper currency increased in circulation, more circles were created. The new system was modelled on the Fixed Fiduciary or the Currency Principle.<sup>3</sup> Notes upto the value of Rs. 4 crores were to be backed by securities and the *whole amount above it* had to be secured against an equivalent amount of silver coin and bullion in the reserves. This arrangement secured *complete freedom from over-issue* but only *at the expense of elasticity* which was particularly desirable on account of the increased demand for currency in the busy season and the comparative absence of banking facilities. "Government gained nothing by the issue of notes as the currency officer had to keep in reserve an equivalent amount in coin or bullion; and so notes were *no more economical* than rupees."<sup>4</sup> The rigidity, that is,

1 Dass Gupta—*Paper Currency in India*—p. 8.

2 This may have been due partly to the desire of the Government to improve the state of paper currency and partly to a more selfish motive of making profit on note-issue.

3 See pp. 25-26.

4 Chabiani—*Indian Currency, Banking and Exchange*—p. 21.

inability to expand and contract, was somewhat relaxed partly by the closing of the mints in 1893 when, the rupee having become a token coin, less silver was required to be kept in reserves than previously,<sup>1</sup> and partly by raising the limit of the fiduciary portion from Rs. 4 crores in 1861 to Rs. 14 crores in 1913. In 1898 a portion of the Paper Currency Reserve, which was originally intended to ensure the encashment of notes, was transferred to England (and kept in gold) for the purchase of silver required for minting rupees. Thus it became a part of the complicated mechanism of the gold exchange standard<sup>2</sup> and was freely drawn upon for the purpose of maintaining the external value of the rupee (through the sale of Council and Reverse Council Bills). In addition to strengthening the gold (or London) portion of the Reserve, the Government endeavoured to universalise notes of smaller denominations with a view to increasing their popularity.

**The Chamberlain Commission.** The Chamberlain Commission (1913) desired to introduce a further measure of elasticity in the organisation of paper currency. Therefore they recommended that the fiduciary portion of the reserve should be increased from Rs. 14 crores to Rs. 20 crores and should thereafter be fixed at a maximum of the amount of notes held by the Government in the Reserve Treasuries plus one-third of the net circulation<sup>3</sup>. The Government should also take power to make temporary investment or loans from the fiduciary portion within this maximum in India and in London as an alternative to investment in

1 A ten-rupee note, for example, could be issued by keeping in reserve silver worth Rs. 6 only.

2 See Chapter X.

3 Meaning gross circulation minus notes held in Reserve Treasuries.

permanent securities. In India the loans should be made to the Presidency Banks and in London the Secretary of State should have the power to lend out sums received in payment of Council Drafts sold against the currency reserve in the busy season, provided that the total cash portion of the Paper Currency Reserve does not fall below two-thirds of the net circulation. They also recommended that the use of notes should be encouraged by all legitimate means. The number of places at which notes were encashable as of right as well as the extra facilities for encashment should be increased and the Rs. 500 notes should be universalised.

The Commission expected many advantages from these recommendations. In the first instance, it would be possible for the Government to lend temporarily from the Paper Currency Reserve, especially during the busy season when a permanent investment would be unwise. The Government would earn considerable interest on sums which would otherwise remain idle while the money market would, by this temporary expansion of currency in the busy season, obtain some relief from the seasonal currency. Secondly, the Government would be able, as the note circulation increases, to add to the permanent or temporary investments of the Reserve without special legislation. Thirdly, the power to make temporary investments in London on account of the Paper Currency Reserve would be a convenience to the Secretary of State in permitting him to sell council drafts against the Paper Currency Reserve in anticipation of silver purchases or of any other cause without the loss of interest and other disadvantages which might sometimes come about if he was compelled, without discretionary power, to use the entire proceeds of such sales in

earmarking gold. Fourthly, the note-issue will not only be more elastic, it would also be more popular.

This Report, however, was still-born. Its recommendations were yet under the consideration of the Government when the War broke out and further consideration was postponed until the return of normal conditions.

**1914-19. The War Period.** During the first year of the War the paper currency system was subjected to a heavy strain. Notes were presented in large amounts for being converted into gold which at first the Government allowed but after losing about £ 1,800,000 between the 1st and 4th of August 1914 the Government refused to issue any more gold to the public. Confidence, however, was quickly restored. From 1915 onwards, the demand for Indian currency (especially paper currency) increased considerably.<sup>1</sup> Owing to the scarcity of precious metals, there was no alternative but to issue notes against securities. The fiduciary portion, therefore, was increased from Rs. 20 crores to Rs. 120 crores on the strength of which, in addition to the notes of existing denominations, new notes of Rs. 2½ and Re. 1 were put into circulation. The public, at first, hesitated to accept the new notes which in the beginning circulated at a discount<sup>2</sup> but so great was the demand for currency that they also got absorbed into circulation. The demand for additional currency

1 Owing to a highly favourable balance of trade and scarcity of metallic currency. Also see Chapter XI.

2 "Discount as high as 15 per cent and 19 per cent has been reported; but the discount rapidly diminished when it was seen that the notes were freely accepted in payment of Government dues and when small coins were made available in large quantities." Gupta—*Paper Currency in India*—p. 109. Also read the *Report of the Commission on Indian Exchange and Currency* (1919), para 29.

was met by the purchase of 200 million ounces of silver from America.

It has been pointed out that the number of securities in the reserves had to be increased to finance the growing trade of India. Owing to the increase in the rate of interest, the market value of these securities declined enormously. "With a view to replacing them gradually by more suitable securities, it was decided to create a Paper Currency Reserve Depreciation Fund out of the interest received on paper currency investments."<sup>1</sup>

**Babington Smith Committee (1919).** On the termination of War, the Indian currency system was carefully examined by the Babington Smith Committee in 1919. The Committee were anxious to see that the note-issue was fairly elastic and, at the same time, backed by sufficient amount of metal in the reserve. Consequently, they recommended :—

- (1) That the legal minimum for the metallic portion of the reserve should be 40 per cent of the gross circulation and that the gold in the Paper Currency Reserve should be re-valued at 2s. to a rupee (instead of 1s. 4d as before the War) ;
- (2) that the limit of the fiduciary portion should, for some time, continue to be Rs. 120 crores of which not more than Rs. 20 crores be securities of the Government of India ;
- (3) that provision should be made for the issue of additional currency in the busy season upto Rs. 5 crores, over and above

<sup>1</sup> Chablani—*Studies in Indian Currency, Banking and Exchange*—pp. 27-28.

the normal fiduciary issue, as loans to the Presidency Banks on the security of export bills of exchange ;

- (4) that silver and gold in the Paper Currency Reserve should be held in India except for purchasing silver in London ; and
- (5) that, as soon as circumstances permit, free facilities for the encashment of notes should be given and the restrictions imposed during the War should be withdrawn. The Government should have the option of redeeming their notes in full legal tender gold or silver coin.

**Acts of 1920 and 1923.** It will be noticed that the Smith Committee made very bold suggestions for increasing the elasticity of paper currency. Forty per cent limit of the metallic portion was *much too low* considering that the masses were illiterate and more accustomed to metallic coins than paper money. The number of securities allowed to be put in reserves was *abnormally high* and, on top of this, there seemed to be hardly any justification for issuing additional currency in the busy season. The Government realised the force of these arguments and modified the recommendations of the Committee which were embodied in the Paper Currency Act of 1920 and the Consolidating Act (No. VI) of 1923. The provisions of the latter Act fall under two classes—permanent and transitory.<sup>1</sup>

(a) *Permanent Provisions.*

- (1) The metallic reserve was to be at least 50 per cent of the total reserve. The reasons for accepting a higher percentage

<sup>1</sup> Prof. Jevons, in his *Money, Exchange and Banking in India* (1927) had hoped that the permanent provisions could be realised in five or six years' time. Later events, however, belied his expectations.

than that suggested by the Smith Committee, which was only 40 per cent, were the necessity of encashing the notes, without question in a country like India, and the necessity of holding sufficient coins in the reserve to finance the movement of crops during the busy season when notes are generally presented for encashment on a very large scale.

- (2) With the exception of Rs. 20 crores worth of securities held in India, the remainder were to be held in England and should be short-term securities not exceeding a period of twelve months as suggested by the Smith Committee.
- (3) The Controller of Currency was authorised to issue notes up to an amount of 5 crores of rupees against discounted bills of exchange maturing within 90 days of their issue. This extra issue should take the form of loans to the Imperial Bank which should pay 8 per cent interest to the Government and deposit accepted bills of exchange with the latter.
- (4) The Secretary of State was not to hold more than five million pounds in gold bullion in London.

(b) *Transitory Provisions.*

Owing to the difficulty caused by the necessity of re-valuing the gold and sterling securities of the reserve on the basis of Rs. 10 to the sovereign, instead of Rs. 15, certain transitory provisions became necessary pending the final attainment of the permanent provisions. With the re-valuation on the 10-rupee basis the metallic portion of the reserve would have been less than fifty per cent.

It was, therefore, provided that the invested portion might, for the time being, be fixed at Rs. 85 crores and that the Government of India be authorised to create rupee securities of their own hand (*'ad hoc'* or *'created'* securities) and to issue them to the Paper Currency Reserve.

It will be seen that the only change of importance was in the minimum percentage of the metallic portion of the reserve which was fixed at 50 per cent instead of 40 per cent as recommended by the Smith Committee.<sup>1</sup>

**1923-1926.** On the establishment of the Imperial Bank in 1921, the power of issuing seasonal currency against inland bills of exchange was entrusted to it and the limit was raised from Rs. 5 crores to Rs. 12 crores in 1923-24.<sup>2</sup> In 1925, the permissible size of security holding, *viz.*, Rs. 85 crores, was felt to be too small and was increased to Rs. 100 crores provided that the value of created securities did not exceed Rs. 50 crores.<sup>3</sup> Two-and-a-half rupee and one rupee notes which were issued during the War period were cancelled in January, 1926.

**The Hilton Young Commission (1926).** The system again came under the searching examination of the Hilton Young Commission in 1926. The Commission recommended that the sole right of note issue should be transferred to the Reserve Bank and the Government notes should cease to

1 But as the power to issue Rs. 5 crores of notes against commercial bills of exchange was authorised, the real limit was virtually reduced to 47½ per cent.

2 Owing to continued monetary stringency.

3 Note that, since 1918, "a large portion of the Indian invested reserve has consisted of "created" securities, that is to say, treasury bills issued by Government to itself. Currency notes were issued by Government against its own I O.U's. and watering down of the currency meant a floating public debt without obligation to pay interest thereon." Kale—*Indian Economics*—p. 530.



be legal tender except at Government Treasuries. The notes of the Bank were to be full legal tender and were to be guaranteed by the Government. The legal obligation to convert paper currency into silver coin was to be withdrawn although facilities were to be given for the free inter-changeability of different forms of legal tender currency and for their ultimate conversion into *gold bars*<sup>1</sup> of not less than 400 ounces at specified rates. The Paper Currency and Gold Standard reserves were to be amalgamated and the proportions and combination of the combined Reserve were to be fixed by statute. The new system was to be based on the Proportional Reserve Principle and the proportion of silver in the reserve was to be substantially<sup>2</sup> reduced during the next ten years.

**Act of 1927.** Most of these recommendations were incorporated in Act No. IV of 1927 according to which the gold value of the rupee was fixed at 8.475 grains per rupee (instead of 11.00316 grains as previously). The Government undertook to buy gold in bars of not less than 40 tolas at Rs. 21-3-10 per tola and to sell gold *or sterling, at the option of the Government*, at the same price after allowing for the cost of transportation from Bombay to London, in amounts of not less than 1,065 tolas. The Bill authorising the creation of the Reserve Bank was rejected by the Legislative Assembly in 1927.

**1927-31.** The Act of 1927 committed the Government to the Gold Bullion Standard *only so long as the sterling was linked to gold*. But in September, 1931, when England abandoned the gold standard<sup>3</sup>, the paper currency came virtually to be linked to sterling.

1 See Chapter XII.

2 From Rs. 85 crores to Rs. 25 crores,

3 See Chapter XII, pp. 173-176.

**The Reserve Bank Note Issue.** With the passing of the Reserve Bank of India Act of 1934, the sole right of note issue has also passed into the hands of the Reserve Bank, although provision has been made for the use of Government of India currency notes during the initial period<sup>1</sup>.

*Issue Department.* The issue of bank notes shall be conducted by the Bank in an Issue Department which shall be separated and kept wholly distinct from the Banking Department.

*Denominations of Notes.* Bank notes shall be of the denominational value of five rupees, ten rupees, fifty rupees, one hundred rupees, five hundred rupees, one thousand rupees and ten thousand rupees.

➤ *Legal Tender Character of Notes.* Every bank note shall be legal tender at any place in British India and shall be guaranteed by the Governor-General-in-Council.

*Bank Exempt from Stamp Duty on Bank Notes.* The Bank shall not be liable to the payment of any stamp duty under the Indian Stamp Act, 1899, in respect of bank notes issued by it.

*Assets of the Issue Department.* The assets of the Issue Department shall consist of gold coin, gold bullion, sterling securities, rupee coin and rupee securities to such aggregate amount as is not less than the total of the liabilities of the Issue Department. Of the total amount of the assets, not less than two-fifths shall consist of

<sup>1</sup> Under the India and Burma (Burma Monetary Arrangements) Order, 1937, the Reserve Bank has also the exclusive right of note issue in Burma.

gold coin, gold bullion or sterling securities<sup>1</sup> provided that the amount of gold coin and gold bullion shall not, at any time, be less than forty crores of rupees in value. The remainder of the assets shall be held in rupee coin, Government of India rupee securities and such bills of exchange and promissory notes payable in British India which are eligible for purchase by the Bank, provided again that the amount held in Government of India rupee securities shall not, at any time, exceed one-fourth of the total amount of the assets or fifty crores of rupees, whichever amount is greater or, with the previous sanction of the Governor-General in Council, such amounts plus a sum of ten crores of rupees.<sup>2</sup> Gold coins and gold bullion in the reserve shall be valued at 8·47516 grains of fine gold per rupee, rupee coin shall be valued at its face value and securities shall be valued at the current market rate. Of the gold coin and gold bullion held as asset, not less than seventeen-twentieths shall be held in British India and all gold coin and gold bullion held as assets shall be held in the custody of the Bank or its agencies. In exceptional circumstances, the Bank may, with the previous sanction of the Governor-General-in-Council, for periods not exceeding thirty days in the first instance, which may, with the like sanction be extended from

1 The sterling securities which may be held as part of the assets shall be securities of any of the following kinds payable in the currency of the United Kingdom, namely:—

- (a) Balances at the credit of the Issue Department with the Bank of England;
- (b) Bills of exchange bearing two or more good signatures and drawn on and payable at any place in the United Kingdom and having a maturity not exceeding ninety days;
- (c) Government securities of the United Kingdom maturing within five years.

2 Note that this clause has been repealed by an Ordinance dated 8th February, 1941 and that there is now no limit to the holding of rupee securities by the Reserve Bank. Also see p. 230.

time to time by periods not exceeding fifteen days, hold as assets gold coin, gold bullion or sterling securities of less aggregate amount provided that the gold coin and gold bullion shall not, at any time, be reduced to less than two-fifths of the total assets. During such period the Bank shall pay to the Governor-General-in-Council a tax, upon the amount by which such holding is reduced, at the current bank rate with an addition of one per cent per annum when such holding exceeds thirty two and a half per cent of the total amount of the assets.

*Liabilities of the Issue Department.* The liabilities of the Issue Department shall be an amount equal to the total of the amount of currency notes of the Government of India and the bank notes for the time being in circulation.

Reserve Bank of India notes were first issued to the public in India in January 1938 when supplies of five rupee notes became available. Ten rupee notes were issued in the following month while Rs. 100 and Rs. 1,000 notes were issued in May 1938. The Bank does not propose to issue Rs. 50 or Rs. 500 notes but Government of India notes of these and all other denominations continue to be full legal tender.<sup>1</sup>

**The Paper Currency Reserve—Its Location and Composition.** It has been seen that the Paper Currency Reserve was instituted in 1861 to ensure the encashment of notes in rupees. It was, therefore, for several years, kept in silver and in India. But in 1898 this policy was, for the first time, departed from and a portion of the Reserve was located in London to be used for the *purchase of silver* required for rupee coinage and also for the *support of exchange*. In 1898 an Act was passed

1. Reserve Bank of India—*Report on Currency and Finance for the year 1937-38.*

enabling notes to be issued against gold held by the Secretary of State in London. Thereafter, whenever the Secretary of State sold Council Bills in excess of his own requirements (in respect of Home Charges) they were paid out of the Reserve in India and the Secretary of State transferred an equivalent amount of gold to the account of the Reserve in London. Thus the Secretary of State used to either (1) hold gold in England as part of the Reserve against the note-issue in India, or (2) transmit the gold to this country to serve the same purpose here, or (3) expend it on the purchase of silver also to form part of the Reserve. It is, therefore, evident that the Reserve, up to April 1935, used to perform a variety of functions. Apart from being used for the conversion of notes, it was regarded as the "first line of defence" in a time of exchange crisis. No wonder, therefore, that its composition and location have depended, from time to time, upon the exigencies of the international trade as the following tables will show.

## COMPOSITION OF THE PAPER CURRENCY RESERVE

(A)

In Crores of Rupees.

Year.	Gross Note Circulation.	GOLD		SILVER		SECURITIES		
		In India.	Out of India.	Coin	Bullion.	Indian.	British Treasury Bills.	Others.
1914	66.1	22.4	9.1	20.5	...	10.0	...	4.0
1915	61.6	7.6	7.6	32.3	.	10.0	...	4.0
1916	67.7	12.2	11.9	23.0	.5	10.0	6.0	4.0
1917	86.3	12.0	6.6	17.0	2.1	10.0	84.4	4.3
1918	99.7	26.8	.6	10.4	.3	10.0	48.1	3.3
1919	153.4	17.3	.1	16.6	20.7	16.9	81.2	1.2
1920	174.5	44.3	8.4	33.2	6.6	19.5	67.2	...
1921	166.1	21.1	...	61.4	4.1	66.0	8.3	...
1922	174.7	24.3	..	72.9	4.5	67.0	5.8	...
1923	174.7	24.3	...	82.5	4.5	57.4	5.8	...
1924	185.8	22.3	...	74.1	5.8	69.5	14.0	...
1925	184.1	22.3	...	70.0	6.7	65.1	20.0	...

## (B)

In Crores of Rupees.

Year.	Gross Note Circulation.	SILVER		Gold Coin and Bullion in India.	Sterling Securities in England.	Rupee Securities in India.	Internal Bills of Exchange
		Coin.	Bullion.				
1926	193·3	77·2	7·6	22·3	29·0	57·1	...
1927	184·1	95·9	8·5	22·3	5·5	49·7	2 0
1928	184·8	98·7	7 6	29 7	3·7	37 9	7 0
1929	188 0	94·9	4·9	32·2	10·6	43·2	2 0
1930	177·2	108·1	2·8	32 2	15·0	33 8	...
1931	160·8	117·8	6 9	25 8	...	10 2	...
1932	178·1	191·9	9 2	5·3		57 9	3 7
1933	176·9	96·3	15·2	25·9		39·1	
1934	177·2	86·5	11·5	41·5	8·2	29 4	.
1935	186·1	79·2	13·1	41·5	18 2	35 9	..

The Act of 1911 fixed the limit of fiduciary issues at Rs. 14 crores of which not more than 4 crores may be in sterling securities invested in London. By the Act of 1919 this limit was raised to Rs. 120 crores. In the beginning, the gold of the Paper Currency Reserve in London used to be kept earmarked with the Bank of England to safeguard the note-issue of the Government of India and was not available to the London money market but the law was soon amended and the Secretary of State was not only empowered to handle the gold of the Paper Currency Reserve without restraint but also to convert most of this gold in sterling securities.

Since the balance of trade was generally favourable to India large funds were kept locked

up in England to the detriment of the trade and commerce of this country. The public objected to the employment of the Reserve for purposes other than those for which it had been created and to the purchase of silver in London. India has a large bullion market and it is capable of great expansion. If the Government purchase silver in this country, the bullion dealers will be greatly benefited without causing any loss or inconvenience to the Government. Moreover, it was unfair to lock up these reserves in England or to use them for the benefit of London money market, especially at a time when the Indian market was literally starving for currency. It is of particular importance, therefore, to remember that, with the establishment of the Reserve Bank in April, 1935, the Gold Standard Reserve and the Paper Currency Reserve have been amalgamated and the entire stocks of gold have been transferred to the Bank. The position of the combined reserve as revealed in the balance sheet of the Issue Department is as follows :—

## RESERVE BANK OF INDIA

## ISSUE DEPARTMENT

An account pursuant to the Reserve Bank of India Act 1934, for the week ending on the 5th day of April, 1935.

<i>Liabilities</i>	<i>Rs.</i>	<i>Assets</i>	<i>Rs.</i>
Notes held in the Banking Department ...	19,05,29,000	A. Gold Coin and Bullion—	
Notes in circulation...	1,66,99,97,000	(a) Held in India	41,55,19,000
Total Notes issued ...	1,86,05,26,000	(b) Held outside India	2,86,98,000
		Sterling Securities ...	48,62,95,000
		Total of A	93,05,12,000
		B. Rupee Coin	49,94,95,000
		Government of India	
		Rupee Securities ...	43,05,19,000
		Internal Bills of Exchange and other commercial papers	...
Total Liabilities ...	1,86,05,26,000	Total Assets	1,86,05,26,000

The liabilities show very little change amounting to Rs. 186.5 crores as against Rs. 186.10 crores of the Currency Department of Government on the last day of 1934-35. On the assets side gold coin and bullion is shown at Rs. 44.42 crores valued at the statutory parity, made up of the gold holdings of the Government of India of the value of Rs. 41.45 crores in the Paper Currency Reserve and Rs. 2.87 crores in the Gold Standard Reserve. Sterling and rupee securities increased respectively from Rs. 18.28 crores to Rs. 48.63 crores and from Rs. 35.90 crores to Rs. 43.05 crores. Rupee coin declined from Rs. 77.25 crores to Rs. 49.95 crores, silver coin and bullion in excess of Rs. 50 crores being no longer held as part of the assets. The gold coin and bullion combined with the sterling securities stood at Rs. 93.5 crores and together amounted to 50.01 per cent of the total liabilities. The following table will give an idea of the subsequent liabilities and assets of the Issue Department of the Reserve Bank of India at the end of each financial year.

(In lakhs of Rupees)

	LIABILITIES			ASSETS					Percentage of gold and sterling securities to total notes issued
	Notes held in Banking Department.	Notes in circulation	Total liabilities (Total Notes issued).	Gold coin and Bullion	Sterling Securities	Rupee coin	Rupee Securities	Total Assets	
1936	24,95	169,98	194,93	44,42	67,32	55,77	24,42	194,93	57.32
1937	13,45	194,55	208,00	44,42	78,06	61,90	23,62	208,00	58.88
1938	24,64	188,92	213,56	44,42	78,81	62,94	27,39	213,56	57.71
1939	13,30	193,52	206,82	44,40	59,50	70,62	32,29	206,82	50.24
1940	13,66	238,54	252,20	44,40	113,50	55,95	38,35	252,20	62.61
1941	11,58	257,65	269,23	44,41	102,24	34,71	87,87	269,23	54.46



**Paper Currency since September 3, 1939.** We have seen in the preceding chapter that since the War began the circulation of notes has increased by more than Rs. 106 crores.

The balance sheet of the Reserve Bank for the week ending March, 28, 1941 also contains some interesting facts. The value of the total notes issued, which constitutes the sole liability of the Bank in its Issue Department, was Rs. 269·23 crores. Of this amount notes to the value of Rs. 11·58 crores were held in the Banking Department of the Bank while notes to the value of Rs. 257·65 crores were in circulation. The assets against this liability were Rs. 44·41 crores in gold coin and bullion, Rs. 102·24 crores in sterling securities, Rs. 34·71 crores in rupee coin and the balance of Rs. 87·87 crores in Government of India-rupee securities. The percentage of rupee securities to total assets was, therefore, 32·6 as against 16·6 on May, 31, 1940. It will also be worthwhile to remember in this connection that the Reserve Bank of India Act allowed only a fourth of the assets to be held in rupee securities but the operation of the Act was suspended by an Ordinance issued on 8th February, 1941.<sup>1</sup>

The assets of the Issue Department, according to the Reserve Bank Act, shall consist of gold coin, gold bullion, sterling securities, rupee coin and rupee securities to such aggregate amount as is not less than the total liabilities of the Issue Department. Of the total amount of assets not less than two-fifths shall consist of gold coin, gold bullion or sterling securities provided that the amount of gold coin and gold bullion shall not at any time be less than Rs. 40 crores in value.

It will be noticed that the value of the gold holdings of the Bank in its Issue Department is

1 Also see page 224.

more than Rs. 4.41 crores above this statutory limit. The gold coin and bullion are valued at 8.47512 grains of fine gold per rupee but at the current market prices the value of the gold holdings is more than Rs. 88 crores.

But a rather distressing feature of the reserves is the high percentage of sterling securities for a little less than half the total note issue is backed by them. "Even in a period of normal political and economic life this would have been undesirable, and it is many times more so when a major war is going on. It is doubtful wisdom for the central bank of any country to invest such a large part of its paper currency assets in securities of a belligerent country. The sterling assets in the Banking Department of the Reserve Bank have no doubt helped the Government in repatriating some sterling loans, but here again it may be asked whether the purpose behind this repatriation move is to make sterling available in England for reinvestment in war bonds. In any case, the sterling assets of the Reserve Bank seem to have exceeded what it would be necessary, desirable and prudent to have."<sup>1</sup>

But all said and done there is, at the moment, behind each currency note, its full value in gold, easily realisable sterling, silver rupees or obligations of the government of India which are realisable at a moment's notice. There are ample stocks of silver rupees at currency offices, treasuries and branches of the Imperial Bank and currency notes can be freely exchanged into rupees.

<sup>1</sup> *The War and the Rupee*, an article by Prof. B. Datta in the *Modern Review*.

Note that the percentage has increased since.

## SUMMARY

**Before 1861.** The notes in India were issued for the first time by the Presidency Banks in the nineteenth century. The maximum amount up to which each bank could issue notes was fixed and they had to keep 33 per cent specie in reserve. The notes were legal tender in a limited area and their popularity was greatly restricted.

**1861-1914.** In 1861 the Government undertook to issue notes themselves through the newly created Paper Currency Department. Notes of the value of Rs. 4 crores were to be backed by securities and the whole amount above it had to be covered by an equivalent amount of gold or silver (Fixed Fiduciary Principle). This system guaranteed freedom from over-issue but only at the cost of elasticity. The rigidity was gradually reduced in 1893 when the rupee became a token coin and by raising the limit of the fiduciary portion from Rs. 4 crores to Rs. 14 crores. In 1898 a part of the Paper Currency Reserve was transferred to England for the purchase of silver and thus became a part of the gold-exchange system. In order to make paper currency still more elastic, the Chamberlain Commission recommended that the limit of the fiduciary portion may be increased to Rs. 20 crores and that temporary loans may be given out of the reserve both in India and in England. No action was taken on the Report due to War.

**1914-1919.** During the first year of the War, notes were presented for conversion into gold but later on the demand increased so enormously that the fiduciary portion had to be increased to Rs. 120 crores and fresh notes of Rs. 2½ and Re. 1 had to be put into circulation with practically no metallic cover.

**Babington Smith Committee.** They recommended that the legal minimum for the metallic portion should be 40 per cent of the gross circulation and that the maximum limit of the security portion should be Rs. 120 crores. They also suggested the issue of additional currency in the busy season against export bills of exchange. By recommending a rather low limit of the metallic portion and by allowing too many securities in the reserve the Committee made the system dangerously elastic. The Government accepted their recommendations with the only difference that the amount of the metallic portion was fixed at 50 per cent instead of 40 per cent. On the establishment of the Imperial Bank the power of issuing emergency currency was entrusted to it and the amount was raised from Rs. 5 crores to Rs. 12 crores.

**The Hilton Young Commission.** They recommended that the right of note-issue should be entrusted to the Reserve Bank. The new notes were not to be legally convertible into rupees but into gold bars of not less than 400 ounces at specified rates. The Gold Standard and the Paper Currency reserves were to be amalgamated and the composition of the combined Reserve fixed by law. Owing to the rejection of the Reserve Bank Bill, the Government could not give effect to these recommendations. By the Act of 1927, the Government undertook to purchase gold from the public in amounts of not less than 40 tolas and to sell gold to the public in amounts of not less than 1,065 tolas at rates calculated on the 18d basis of the rupee but even this arrangement fell through in 1931 when England abandoned the gold standard and our currency, including paper notes, came to be linked to sterling.

**The Reserve Bank Note-issue.** With the passing of the Reserve Bank Act of 1914, the paper currency system has entered a new phase. The power of issuing notes has been transferred to the Reserve Bank and is exercised through the Issue Department which is quite distinct from the Banking Department. Of the assets of the Issue Department, not less than  $\frac{2}{3}$ ths shall consist of gold or sterling securities, provided that the amount of the metallic portion shall not at any time, be less than forty crores of rupees, and the rest shall be held in rupees, Government of India securities, bills of exchange and promissory notes which the Reserve Bank is allowed to deal in. Of the metallic portion at least  $\frac{17}{20}$ ths shall be kept in British India.

**The Paper Currency Reserve.** It was originally created to ensure the encashment of notes but it has gradually become a very important part of the machinery of the gold exchange standard. It was freely drawn upon for the purchase of silver and for selling Council Bills etc. The public has always resented this misuse of reserves and feels greatly relieved now that the Gold Standard Reserve and the Paper Currency Reserve have been amalgamated and the combined reserve is maintained in India.

**Paper Currency since September, 3, 1939.** The War has not affected our paper currency system too badly. Additional notes of the value of about Rs. 100 crores have been issued but they have adequate metallic backing. The percentage of rupee and sterling securities has, however, increased.

## QUESTIONS

1. Give a short history of the Indian Paper Currency System from 1861 to 1914.

[Delhi Inter. 1929 and 1934].

2. What do you mean by "elasticity"? Examine the recommendations of the Chamberlain Commission and the Babington Smith Committee to remedy the inelasticity of the Indian Paper Currency System.

[Delhi Inter. 1928]

3. What is the proper function of the Paper Currency Reserve? How is the Reserve actually used? Explain why its composition and location are changed from time to time.

[Delhi Inter. 1931].

4. What is the connection between the Gold Standard Reserve and the Paper Currency Reserve? Are you in favour of keeping them separate? Give reasons.

[Punjab B.A. 1932].

5. Point out the salient features of the Indian Paper Currency System as it exists at present.

[Delhi B.A. 1931].

## CHAPTER XV

### BANKS AND BANKING

**Definition of a Bank.** The trade of banking has been exercised from very early times. The nature of business transacted by the banks has varied so widely from age to age and from country to country that it is impossible to define a bank. The art of banking originated with the goldsmiths who did no more than change one currency for another and enabled merchants to obtain good currency at a time when a great variety of debased coinage was in existence. Even to-day, the indigenous money-lenders are called bankers although they do not perform any of the recognised functions of modern banks, namely, receiving of deposits, dealing in bills of exchange, or issue of notes etc. Walter Leaf has defined a bank as "a person or corporation which holds itself out to receive from the public, deposits payable on demand by cheque." This, as he has himself admitted, holds good for Great Britain and perhaps United States, but not for the Continent "where the use of cheque is too little developed to be regarded in any sense as a fundamental part of the functions of a bank." Referring to the several ingenious definitions of 'Banks' put before them, the Central Banking Committee stated, "Fairly exhaustive and helpful as these suggestions are, we find that the task of defining the term 'Banks' or 'Banker', which has been regarded as well-nigh impossible in other countries, is much more so in India where the definition cannot be drawn up without excluding

many firms of indigenous bankers and individuals who do a considerable portion of the financing of the country.”<sup>1</sup> “Taken in its general acceptance, word ‘Bank’ expresses among us to-day the business which consists in affecting, on account of others, receipts and payments, buying and selling either money of gold and silver or letters of exchange, and drafts, public securities and shares in industrial enterprises; in a word, all the obligations whose creation has resulted from the use of credit on the part of states, societies and individuals.”<sup>2</sup>

**Functions of a Bank.** From this comprehensive definition we get an idea of the usual functions of a bank. In the first instance, it attracts *deposits* on which it pays a reasonable rate of interest. Deposits may be received on Current Account whereby the banker incurs an obligation to repay legal tender on demand, on Savings Bank Account in which case the depositor is not allowed to draw more than a fixed sum of money more than once or twice a week, and on Fixed Deposit Account which is withdrawable only on the expiry of the period for which it has been entrusted to the bank. Secondly, the money thus collected, together with the capital raised from the share-holders, is used for giving *loans* to the business people at higher rates of interest. The difference between the rates of interest charged from their debtors and paid to their creditors (depositors) constitutes

1 *Report*—p. 453. An attempt has been made to define Banking by the addition of Section 277—F to the Indian Companies Act of 1936. According to this, a “Banking Company” means a company which carries on, as its *principal business*, the accepting of deposits of money on current account or otherwise subject to withdrawal by cheque, draft or order notwithstanding that it engages in addition in any one or more of the following forms of business etc. etc.”

2 Gautier quoted by Conant—*Principles of Money and Banking*, Vol. II, p. 207.

their profit. Loans are sometimes given against personal security or against mortgaged property but more often against commercial bills of exchange which they *accept and discount* on behalf of their clients. Thirdly, they facilitate the *transfer* of money from one part of the country to another where they have their branches. Fourthly, they keep valuable articles in safe custody and act as agents to their clients for the purpose of buying gold, silver, shares and securities, for the collection of dividends and for the payment of insurance premia, etc.<sup>1</sup> Some banks issue notes and act as bankers to the governments of their country. They are commonly called Central Banks. In addition to these, there are specialised institutions created for specific purposes only viz., Industrial Banks, Land Mortgage Banks, Post Office Savings Banks etc.

**Loans Make Deposits.** It has been observed that one of the most important functions of banks is to lend money. The amounts lent are seldom taken away by the debtors. They are left in the bank and drawn upon from time to time by means of cheques. Every loan by the bank, therefore, creates a deposit. Such deposits are called 'Credit Deposits' to distinguish them from 'Cash Deposits' which are created by spare money being entrusted to the banks by their creditors. The same amount is shown as a loan to an individual in one ledger and as his deposit in the bank in the other.<sup>2</sup>

1 "Ordinary banking business consists of changing cash for bank deposits and bank deposits for cash; transferring bank deposits from one person or corporation to another; giving bank deposits in exchange for bills of exchange, government bonds, the secured promises of business men to repay, and so forth." Sayers—*Modern Banking*, p. 22.

2 Referring to Great Britain, Mr. Hartley Withers has remarked that out of the total deposits of the five biggest commercial banks amounting to 1,666 million pounds, 1,249 millions consist of credit deposits and only 417 millions of cash deposits. See his—*The Meaning of Money*.



It will be wrong to suppose that the whole amount lent by the banks will be allowed to remain with them. Some borrowers will certainly withdraw a part of their deposits in cash to meet their liabilities to others. It is, however, possible that these "others" may be customers of this or other bank and the amount lent by the banks may eventually return to them. In other words, so long as the loan is due, a deposit to that amount will be outstanding in the books of some bank or banks.

**How Much may the Banks Lend ?** The amount which a bank may safely lend depends upon the amount that is likely to be withdrawn by depositors in a given period of time. If the depositors are expected to withdraw more money or more frequently, the percentage of cash to deposits must be large and *vice versa*. If the banks keep more cash than is required for meeting normal liabilities, the money will remain idle and the profits of the bank will dwindle. But if the banks, in their greed for making profit do not keep sufficient cash in reserves, there may be a sudden run on them and they may have to close their doors for good. It may be mentioned in passing that one of the causes of successive bank failures in India has been a very low percentage of cash to deposits usually maintained by the Indian banks.

**Circumstances Determining the Adequacy of a Given Cash Reserve.** To earn profits at all the banker must maintain confidence. To maintain confidence he must maintain an adequate degree of *liquidity* in his assets. The perfectly liquid asset is of course cash itself. The more cash a banker holds the more obviously can he, without any difficulty of any kind, offer cash in exchange for deposits. The amount of cash reserve maintained by a bank depends upon the business

conditions of the community in which the bank is operating and more particularly upon the kinds of clients that it has and the nature of their business. Thus, in a manufacturing and commercial community, where exchanges are numerous and rapid, it might be necessary to maintain a relatively larger reserve than would be necessary in an agricultural community where exchange transactions are much less frequent. Even in agricultural areas, it might be necessary to maintain a larger reserve in the busy season than in the slack season. Again, where the use of cheque as currency is wide-spread the bank can exercise a good deal of economy in respect of cash reserve but such economy cannot be practised in a country like India where the bulk of payments has to be made in metallic money and notes. A bank with an extensive town business may require a larger amount of cash reserve than a bank with wider connections with the rural portion of the country. Lastly, a bank with numerous branches can centralise the reserves and thus carry on its business with a smaller reserve than if each of the branch banks was independent of the other.

### **Bank's Investment As Secondary Reserve.**

Apart from maintaining a reserve of cash, a bank has to arrange its investments in such a way that they constitute a supplementary or secondary reserve. As a matter of fact the bank has in actual cash only a percentage of its outstanding demand liabilities, *i.e.* liabilities payable in cash on demand. Increased need for cash can be met only through the sale of some of the bank's assets. These assets, therefore, should carry the least amount of risk and should be readily saleable without any loss otherwise it will not be possible for the bank to get an additional supply of ready

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money where an occasion demands it.<sup>1</sup> The bank has to arrange its investments very cautiously both from the point of view of security and saleability. It should first give loans against commercial paper representing goods in transit or against stocks and shares of well-known companies. This investment should be so arranged that a few bills are constantly maturing and that a good many should mature before the day on which large withdrawals are likely to be made. It may next consider the advisability of advancing money against staples such as wheat and cotton for which the farmers usually receive certificates from the warehouses. Loans may also be given against household property but not without thorough investigation because these securities do not have a ready market and may not be disposed of without sustaining heavy losses.

**How Do Banks Create Credit Money?** The banks can create credit in two ways, viz: (a) by issuing notes, and (b) by giving loans to businessmen and creating deposits in their favour.

Every bank issuing notes has to keep adequate reserves. As all the notes issued are not likely to be presented for the purpose of being exchanged in metallic money, only a small percentage of notes is backed by metal and the rest is covered by securities. These notes circulate as money so long as the credit of the bank is good. A bank issuing notes thus creates credit and provides purchasing power to the business community.

As regards the second point, it has been shown that banks do not accept deposits for the mere fun of keeping money with themselves. They use them as basis on which they organise credit with which they finance economic activities.

<sup>1</sup> Also see Sayers—*Modern Banking*, pp. 212-232.

“Every unit of money that is not kept in actual circulation or not hoarded but is deposited in banks, serves the purpose of at least 5 units. This may appear as a paradox but will be apparent on little explanation. Let us assume that banks keep 20 per cent of their deposits as cash with themselves and the rest they lend. This is the usual practice. And if the sums advanced are again deposited with the banks,  $\frac{4}{5}$ ths of these will again be lent and so on *ad infinitum*. This is, of course, on the assumption that the banking system is sufficiently developed and the amount of money going in actual circulation by actual withdrawals from the banking organisation as a whole is small. Thus the total cash with banks satisfies claims of depositors upto at least five times its amount. Claims for money on banks may either be in respect of original savings deposited or in respect of advances made subsequently therefrom. If banking is developed sufficiently, the cash percentage may safely be reduced to 15 in which case every unit deposited serves the purpose of 7 units.”<sup>1</sup>

**Advantages of Banks.** From what has been said above, it will appear that banks render very useful service to community. They collect from thousands of depositors small sums of money which would have otherwise remained idle or would have been used up for unproductive purposes. These sums of money are put at the disposal of more capable businessmen who do not possess sufficient money of their own but who are quite competent to guide and control the productive operations of the country. “Thus a bank acts as a medium for transferring capital from those who possess it but do not know how to use it or have not the time to use it to the advantage of all concerned, depositors,

1 Thakur—*Organisation of Indian Banking*—p. 15.

bankers and borrowers alike.”<sup>1</sup> They create credit which is the ‘life-blood’ of trade and industry and mobilise the possible wealth of the country for industrial and agricultural operations. By dealing in bills, selling drafts or orders and issuing letters of credit, banks facilitate the transmission of money. They also help the movement of commodities within the same country and from one country to the other. They promote habits of saving and thrift and afford to customers, through the use of cheques, records of payments and receipts which cannot be disputed. Such banks as are allowed to issue notes adjust the amount of different kinds of circulating media to the shifting requirements of trade and economise the use of precious metals by replacing them by paper currency. They serve as a central institution—a Bankers’ Bank—which fulfils the same function in relation to all banking institutions within the country that a simple bank fulfils in relation to individual depositors and holders of funds.<sup>2</sup>

**Requisites of Sound Banking.** Banking is an essential economic activity of human society upon the extent and sufficiency of which depends its proper economic advancement. It is, therefore,

1 Wadia and Joshi—*Money and Money Market in India*—p. 151.

2 According to Mr. Thakur, the services of banks run in the following directions :—

- (i) Mobilisation of savings and the inculcation of habit of thrift.
- (ii) Organisation of credit on the basis of money deposited with them.
- (iii) Financing of human activities.
- (iv) Exchange and transmission of money.
- (v) Management, control, and issue of Bank Notes—a form of money usually adopted by all the principal civilised countries.
- (vi) Regulation of money market.

necessary that it should be organised and controlled by the most competent people who have the necessary *ability* and *honesty* to inspire public confidence. Such people should be familiar with the requirements of each industry and every section of the community and should be qualified to adapt recognised banking practices to their peculiar circumstances. Since the fate of commerce and industry of a country is intimately linked with its financial organisation, it is also desirable that the banks should be run on purely *national* lines. Foreign capital and experts may be imported, if necessary, in the initial stages but they should on no account be allowed to divert their policies in channels prejudicial to the interests of the nation they profess to serve. The success of banking also depends upon the nature and *state of literacy* of the masses. It should, therefore, be the duty of banks to educate the people in matters of thrift and investment. Last but not the least, the presence of a *sympathetic Government* always willing and able to appreciate and promote the legitimate aspirations of its subjects is also a necessary condition for sound banking.

**Balance Sheet of a Bank.** Banks are essentially business institutions and have to publish periodical statements of account for the benefit of their clients. These statements which show the nature of business transacted and the general financial condition of the institution to which they relate are called 'balance sheets'. A typical balance sheet has two columns—Liabilities and Assets. The 'Liabilities' side includes the amounts of money which the bank owes to its shareholder, depositors and others. The 'Assets' side gives details of sums which other people owe to the bank and over which the bank has a claim. It should be remembered that each bank follows its own



method of presenting accounts to the public. Owing further to the difference in the nature of business undertaken by each institution, the balance sheets are bound to differ in minor details. There will, however, be no difference in the major points brought out in each statement. Items which are usually entered in the 'Liabilities' column are:—

1. *Paid-up Capital.* It is the price of the shares actually paid-up and frequently represents only a fraction of the nominal value of the shares called the subscribed capital. This amount the bank owes to its share-holders.
2. *Reserve.* It consists of the undivided profit which may have been set aside for unforeseen emergencies. This is also owed to share-holders.
3. *Public Deposits,* that is, balance of the Government funds entrusted to the bank.
4. *Other Deposits* include loans given by private individuals to the bank for a fixed period (Fixed Deposits) or with the intention of drawing upon them at will (Current Accounts) or at specified intervals and in limited amounts only. (Savings Bank Deposits).
5. *Acceptances* denote the amount of bills which the bank accepted on behalf of its clients and to the extent of which it is liable to the drawers or payees.
6. *Profit* accruing to the bank in the period covered by the balance sheet.

The following items, ordinarily, appear on the 'Assets' side:—

1. *Cash in hand and at other banks.*
2. *Cash at call and short notice*, that is, the amount of loans which can be called up forthwith or at a short notice.
3. *Bills Discounted* denote the amount of money advanced against or spent in purchasing inland and foreign bills of exchange and payable on maturity of such bills.
4. *Government Securities* purchased by and in possession of the bank.
5. *Other Investments* represent the amount of money spent in purchasing shares and stock of private companies.
6. *Advances and Loans* include sums of money advanced against property, ornaments, and other tangible securities.
7. *Acceptances*, that is, the amount due to customers on whose behalf bills have been accepted and who are responsible to the bank for meeting the bills when they fall due. The amount is exactly identical with that mentioned in column of 'Liabilities' under 'Acceptances' (5).
8. *Bullion* represents the value of precious metals possessed by the bank.
9. *Deadstock or premises.* It shows the value of property of all descriptions on which the bank does not earn any profit or interest *e. g.* buildings, furniture, stationery etc.<sup>1</sup>

<sup>1</sup> Read also Hartley Withers—*International Finance*—pp. 35-36.

## SPECIMEN OF BALANCE-SHEETS

## A. IMPERIAL BANK OF INDIA

BALANCE SHEET AS AT 31ST DECEMBER 1934.

<i>Liabilities.</i>		<i>Assets.</i>	
Paid-up Capital	Rs. 5,62,50,000	Cash	... Rs. 18,97,38,000
Reserve ...	.. 5,35,00,000	Balance with	
Public Deposits	.. 6,72,20,000	other banks	.. „ 5,25,000
Current, Fixed and		Investments	... „ 41,55,70,000
Other Deposits	.. 74,27,95,000	Bills discounted	
Sundries	.. 93,48,000	and purchased	... .. 2,59,32,000
		Loans and	
		Advances	... „ 26,42,44,000
		Dead Stock	... „ 2,45,90,000
		Sundries	.. 85,13,000
Total Rs. 92,91,13,000		Total Rs. 92,91,13,000	

## B. STATEMENT OF THE AFFAIRS OF THE

## RESERVE BANK OF INDIA

## BANKING DEPARTMENT

AS ON THE 5TH APRIL, 1935.

<i>Liabilities.</i>		<i>Assets.</i>	
	Rs.		Rs.
Capital paid-up	... 5,00,00,000	Notes	... 19,05,29,000
Reserve Fund	... 5,00,00,000	Rupee Coin	... 3,30,000
Deposits—		Susidiary Coin	.. 1,04,000
(a) Government	... 18,36,41,000	Bills Discounted	...
(b) Banks	... 7,82,07,000	(a) Internal	...
(c) Others	... ..	(b) External	...
Bills payable	... 43,000	(c) Government of India	...
Other Liabilities	1,85,000	Treasury Bills	
		Balances held abroad	11,94,95,000
		Loans and Advances to	
		the Government	
		Other Loans and	
		Advances	
		Investments	... 5,00,0,0000
		Other Assets	16,18,000
Total Rs. 36,20,76,000		Total Rs. 36,20,76,000	

**Bankers' Clearing House.** An important feature of the modern banking organisation is the

Clearing House. It is a well-known fact that persons who do not carry cash with them pay their creditors by cheques. The people receiving these cheques rarely present them to the banks upon whom they are drawn for payment. They send them to their own bankers for collection and for being credited to their accounts. Banks thus establish claims over others in respect of cheques, bills etc., drawn in their favour and payable by the latter. Now, if the amount of money to be collected is very great, each bank will have to depute special clerks for going round other banks for the purpose of settling mutual indebtedness. In order to economise a good deal of time and shoe-leather, instead of going to each bank to present their 'charge' upon it, they all meet by agreement at one place and make their settlement together. Such a place is called a 'Clearing House.' The process of clearing is very simple. All bills and cheques, as soon as they are received by a bank from its customers for collection and are duly recorded for credit of their respective accounts, are passed on to its own Clearing Department where they are sorted out and a list of money to be received from other banks is made. This list is sent through a runner or a clerk to the Clearing House and the amount payable by each bank is noted by its representatives. After all the cheques and bills are received and delivered, the balances are struck and each bank knows what it has to receive from and pay to each of the other banks. The differences are made up and each bank is debited or credited with the balance it has to pay

or receive in the Clearing Bank's Account. The balances are not actually paid but necessary adjustments are made in the separate accounts maintained by the member banks with the Clearing House—the amount due to them being credited to, and their liabilities being deducted from, their respective accounts. The Clearing House's Account must be balanced up every evening because inter-bank payments and receipts must always be equal.

The advantages of this system are evidently many. All the large payments are made with a minimum of risk, loss of time, trouble or use of the precious metals.

Before the establishment of the Reserve Bank the Imperial Bank served as a Clearing House in India although upto 1928 all the transactions were not effected through the Clearing House, as in Bombay, and inter-bank transactions were adjusted by direct credit or debit with the Imperial Bank. The work of the Clearing House is now undertaken by the Reserve Bank at 8 places, *viz.* Calcutta, Bombay, Madras, Rangoon, Karachi, Cawnpore, Lahore and Delhi—the last named having been instituted in 1935-36. The members consist of the Reserve Bank, Imperial Bank, most of the Exchange Banks and English Banking Agency firms and a few of the better known of the local Joint Stock Banks. No bank is entitled to claim to be a member as of right and any application for admission to the Clearing House must be proposed and seconded by two members and be subject thereafter to the approval of the majority of the existing members. That the amounts which pass in this way through the Clearing are gigantic is proved

by the figures of the principal Clearing Houses of India.

TOTAL AMOUNT OF CHEQUES CLEARED ANNUALLY  
(IN LAKHS OF RUPEES)

Year	Calcutta	Bombay	Madras	Karachi	Rangoon	Cawnpore	Lahore	Delhi	Total
1926	10,12,19	4,45,05	56,80	36,14	1,25,33	6,16	6,86	...	16,88,53
1927	9,61,01	4,22,68	54,53	31,07	1,24,42	8,16	7,70	..	16,09,57
1928	10,54,02	3,89,80	59,79	30,82	1,25,57	7,00	7,59	..	16,74,59
1929	10,94,00	6,52,35	65,73	28,02	1,25,00	7,31	8,69	...	19,81,10
1930	9,60,97	7,93,66	82,19	26,49	1,20,70	7,56	8,17	.	19,99,74
1931	8,66,28	6,66,61	50,36	24,47	1,06,55	5,71	10,67	..	17,30,65
1932	7,31,09	6,23,82	43,97	23,23	78,90	5,63	9,02	..	15,15,66
1933	7,90,37	6,67,42	48,85	25,56	70,75	7,08	8,50	...	16,18,53
1934	8,30,18	6,55,47	53,19	26,78	56,12	8,88	9,88	...	16,41,20
1935	8,75,69	6,89,17	56,22	28,96	61,03	10,43	10,43	...	17,33,01
1936	9,18,68	7,16,74	69,23	30,12	72,00	11,16	11,16	13,73	18,43,35
1937	9,23,68	7,62,38	91,39	31,94	83,75	11,40	11,40	15,61	19,31,66
1938	9,66,93	8,15,56	109,67	35,53	82,07	11,21	11,21	18,27	20,51,12
1939	10,76,11	8,37,22	97,21	35,57	94,57	.		...	22,59,05

### SUMMARY

**Definition of a Bank.** It is difficult to define a bank especially in India where the indigenous money-lenders do not perform any of the recognised functions of a bank and yet constitute an important part of the Indian Money Market. Broadly speaking, a bank may be defined as a credit institution which receives deposits, gives loans and purchases precious metals, shares and securities on behalf of its clients.

**Functions of a Bank.**

- (i) To attract deposits—Current, Savings and Fixed.
- (ii) To give loans.
- (iii) To accept and discount bills of exchange.
- (iv) To transfer money from one place to another.
- (v) To keep valuable articles in safe custody.

- (vi) To act as agent for its clients.
- (vii) Some banks issue notes and act as Government Bankers and are called Central Banks.
- (viii) Some banks perform special functions only, viz., Industrial Banks, Land Mortgage Banks etc.

**Loans Make Deposits.** People deposit money by delivering cash at the bank (Cash Deposits) or by borrowing money from the bank and leaving it there to be drawn at a later date (Credit Deposits).

**How Much May a Bank Lend.** A bank ought to keep a reasonable portion of cash to meet its current liabilities in respect of deposits and invest the rest in different kinds of securities maturing at convenient dates. The amount of the reserve will depend upon the business conditions of the community and the requirements of their clients. Normally more money will be required in a manufacturing country or in a country where the use of cheque is not properly developed. A bank with numerous branches can afford to keep a smaller reserve than a bank whose branches work independently of each other.

**How do Banks Create Credit.** The banks create credit partly by putting in circulation notes to a value greater than the value of the coin or bullion which it holds as "backing" for them and partly by giving loans to business-men and creating deposits in their favour.

**Advantages of Banks.** They collect the small savings of the poor and make them available for productive operations, transfer money and goods from one place to another and stimulate habits of investment and thrift. The Central Banks control and regulate the supply of money and coordinate the activities of other financial institutions of a country.

**Requisites of Sound Banking.** Since the economic advancement of a community depends upon sound banking, it is essential that the management of banks should be entrusted to competent people who have the will and ability of inspiring universal confidence. Banks should also be run strictly on national lines adequately supported by a sympathetic government.

**Balance Sheet of a Bank.** A balance sheet is a statement of accounts. It has two sides—the 'Liabilities' side representing amounts which the bank owes, and the 'Assets' side showing amounts which the bank has to receive. The 'Liabilities' column includes paid-up capital, reserves, deposits, acceptances and profits while the 'Assets' side includes cash

in hand and at other banks, cash at call and short notice, bills discounted, investments, acceptances, bullion and dead-stock.

**Bankers' Clearing House.** In civilised communities payments are made and received by cheques with the result that the banks have frequently to receive huge amounts from some banks in respect of cheques drawn on others and deposited with them and to pay to several other banks in respect of cheques drawn by their creditors and presented to others for encashment. In order to avoid the trouble and inconvenience of inter-bank transfer of money, they decide upon a particular bank and all debts are settled through it. Such a bank is called a Clearing House. In India the Reserve Bank functions as a Clearing House for approved banking institutions except where it has no branch. In such places the Imperial Bank takes the place of the Reserve Bank.

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### QUESTIONS

1. What is a bank? [Delhi Inter. 1929].
2. What services are performed by bankers? Is the village *mahajan* a banker in the true sense of the term? [U. P. Inter. 1928].
3. What is a cash reserve? On what does the adequacy of a given cash reserve depend?
4. Explain:—
  - (a) "Loans create deposits." [Calcutta B. A. 1930].
  - (b) "Bank deposits have in modern times changed from deposit of cash to deposit of credit". [Calcutta B. A. 1927].
5. By what principles should a banker be guided in granting credits to his customers? What investments are most suitable from the banker's standpoint? [Punjab B. A. 1932].
6. Give a specimen of the balance sheet of a bank and bring out the significance of each item.
7. Write brief explanatory notes on :—
  - (a) Requisites of Sound Banking.
  - (b) Bankers' Clearing House. [Agra B. A. 1932 and 1934].



## CHAPTER XVI

### BANKING AND THE INDIAN MONEY MARKET

**Constituent Members of the Indian Money Market.** The Indian Money Market consists of:—

1. The Indigenous Bankers.
2. Joint Stock Banks, including
  - (a) Indian Joint Banks.
  - (b) Foreign Exchange Banks; and
  - (c) Imperial Bank.
3. Reserve Bank of India.

Some writers also include in the Banking System the Post Office Savings Banks, the Co-operative Banks, the Land Mortgage Banks, Stock Exchanges and Insurance Companies etc., but since they concentrate on special forms of banking only and do not ordinarily come in contact with other members of the money market, some of them will not receive more than a passing reference here.

**The Indigenous Bankers.**<sup>1</sup> It is a well-known fact that a system of banking eminently suited to her requirements was in force in India long before the introduction of scientific banking in England.

<sup>1</sup> Dr. L. C. Jain has distinguished between an indigenous "banker" and a "money-lender"—the former term being applied to those individuals or private firms which, in addition to giving loans, either receive deposits or deal in *hundis*, the latter to those which make loans but do not usually receive deposits or deal in *hundis*. *The Monetary Problems of India*, p. 55.

The Central Banking Enquiry Committee have tried to make the distinction clear by saying that while the bankers finance trade and industry rather than consumption, the money-lenders finance consumption rather than industry.

The ancient bankers combined banking with trading with the result that with sudden changes in trade conditions several of them came to grief. The survivors, known by a variety of names such as *Mahajans*, *Sahukars*, *Banias*, *Shroffs*, *Chettis*, *Multanis*, etc., continued to render useful service to industry, trade and agriculture and are still the only means of banking assistance in many parts of the country. According to the Census of 1931, the number of people engaged in banking, money-lending and allied activities is a little over 3 lakhs but no authentic statistics are available about the total volume of their business. Considering, however, that the total volume of internal trade (which must be at least ten times that of the external trade) would amount to Rs. 2,500 crores<sup>1</sup> of rupees, it is quite reasonable to expect that a very large part of it must be financed by indigenous agencies. This conclusion is further reinforced by the fact that even in cities like Bombay, Calcutta and Delhi, where there is no dearth of modern banks, we find native merchants settling their transactions by means of *hundis* at rates definitely *higher* than the bank rate. The business of the indigenous banks is purely a family concern and passes from one generation to another. They lend money against different kinds of securities including land, jewellery, and commercial paper. Few of them use cheques and accept deposits—immense inherited wealth being sufficient for their lending operations. They discount and purchase *hundis* offered by their clients and help the movement of funds from one centre to another by drawing *hundis* upon their agents and friends. Some speculate in money, grain, cotton and securities, some are jewellers and shopkeepers and some act as agents of mercantile firms. In short, they finance the agriculturist, the petty artisan and the small trader, assist in the movement of crops to consuming areas or to the ports, and

<sup>1</sup> See K. T. Shah—*Trade, Tariff, and Transport*—p. 122.

distribute all kinds of goods in the interior of the country. They are of very real service to the business community and of very great assistance to the joint-stock banks of the country. Under present conditions the banks run on modern lines can never hope to be able to get into sufficiently close touch with the affairs of the vast trading community in India to enable them to grant accommodation to more than a few of these traders direct and it is in their capacity as middlemen that the *shroffs* prove of such great service. Their real importance, however, lies in the fact that they lend money against almost any conceivable security without insisting upon embarrassing formalities. They are frequently criticised<sup>1</sup> for keeping mysterious accounts and for charging usurious rates of interest but the critics forget the risk and the cost of collection that the *sahukars* have to incur in dealing with their illiterate and irresponsible clients. Moreover, "the pleasant manners, alertness and personal interest of the bankers and money-lenders alike are invaluable assets which are lacking in the case of modern Indian joint stock banks."<sup>2</sup> These bankers will do well to change their obsolete methods and to bring them more into line with the methods of modern banks especially in the

1 The most questionable practices connected with money-lending are:—

- (a) demand for advance interest;
- (b) demand for a present for doing business, known as *giyah-kholai* (purse-opening);
- (c) taking of thumb impression on a blank paper with a view to inserting any arbitrary amount at a later date if the debtor becomes irregular in payment of interest,
- (d) general manipulation of the account to the disadvantage of the debtor;
- (e) insertion in written documents of sums considerably in excess of the actual money lent; and
- (f) taking of conditional sale deeds in order to provide against possible evasion of payment by the debtor. *Report of the Central Banking Enquiry Committee*, p. 77.

2 Jain—*The Monetary Problems of India*—p. 163.

matter of audit-of-accounts, publication of balance sheets, use of bills and cheques, the necessity for prompt payment and receipt of money and the conduct of business strictly in accordance with legal requirements.

These bankers have fallen on evil days lately. Their decline may be attributed to their antiquated methods, to the legal difficulties under which they labour, the apathy of the legislators, provision of cheap and safe remittance facilities and the competition of other credit agencies especially co-operative credit societies. They also deal in stocks and shares which is not the business of a scientific banker who must avoid speculative dealing at all costs. They have ceased to advance money against land in provinces where Land Alienation Act is in force and their operations will tend to be further curtailed by the passage of agrarian bills such as those which have been recently passed in the Punjab and are contemplated in other provinces. Loss of agency business in *Hundis* owing to exporting firms having established their own branches and heavy stamp duty on bills have also proved their undoing. They work more or less independently of joint-stock banks. In the busy season, the indigenous bankers do approach the joint-stock banks for accommodation; but for the most part of the year the bazaar rates are not influenced by the bank rate. The Central Banking Enquiry Committee have suggested that in order to restore the indigenous banks to their ancient place of pride, such of those as are engaged in banking proper or are prepared to shed their business other than banking, should be eligible to be placed on the approved list of the Reserve Bank in the same manner as the joint-stock banks provided they keep proper accounts and have them periodically audited by recognised

auditors.<sup>1</sup> "With the same purpose in view, the Reserve Bank and the commercial banks in India may use such indigenous bankers who are members of the Reserve Bank system as agents for collection of cheques and bills in the same manner as they may use a joint-stock bank or a co-operative bank."<sup>2</sup>

Sir J. B. Taylor has recently drafted a tentative scheme<sup>3</sup> in order to ensure the linking of the indigenous bankers with the Reserve Bank of India. It lays down the minimum limit of capital of all private banks seeking direct access to the Reserve Bank at 2 lakhs of rupees which should be increased to five lakhs within five years. It does not insist on compulsory deposit for this experimental period of five years provided that the amount of time and demand liabilities remains less than five times the capital. Other conditions which should be stipulated for such banks are:—

- (1) They must confine their business to banking proper as defined by the Indian Companies Act of 1936. Any other business that they might be conducting should be wound up within a reasonable time.
- (2) They must maintain proper books of account and have them audited by registered accountants. The Reserve Bank will have the right to inspect the accounts and call for any information necessary to determine the financial status of the banker.

1 *Report*—p. 107.

2 *Ibid*—p. 109.

3 Issued on August 26, 1937. See Annexure to the *Statutory Report* of the Reserve Bank pp. 56-58.

- (3) They must file with the Reserve Bank the periodical statement prescribed for scheduled banks. They must also, in the interest of their depositors, publish the returns prescribed for banking companies by the Companies Act and be liable to the same penalties for non-compliance.
- (4) The Reserve Bank will have the right of regulating the business of the bankers on proper banking lines, when necessary.
- (5) If they satisfy the above conditions they will have the privilege of re-discount with the Reserve Bank against eligible paper, the right to secure advances against Government paper, and remittance facilities similar to those for the scheduled banks.

Those indigenous banks who would not be eligible for direct Reserve Banking facilities under this scheme might organise themselves on a joint-stock basis into discount companies with membership confined to themselves within a given area. The Reserve Bank would be prepared to discount their papers when presented through such discount houses subject to the usual central banking principles. By this method the indigenous banker would not be required to make such a complete change in the present banking methods.

This scheme will be a tentative one for a term of five years but before the end of this period the Reserve Bank will frame proposals for legislation if it thinks fit further to co-ordinate or regulate the position of private banker. It is likely that such legislation would take the form of a

separate Bank Act as suggested by the Banking Enquiry Committee or otherwise to standardise and co-ordinate the status of their registered private bankers on lines in consonance with the scheduled banks.

This scheme was circularised among the bankers concerned for opinion. The replies received, however, do not appear to be quite sympathetic. The Bombay Shroff Association, for instance, feels that "no valuable privilege has been held out to the indigenous banker and no facility has been offered hitherto to make him go out of his way to curtail his activities and to adopt forms of business which are convenient to the joint stock banks but which would be somewhat inconvenient to him." The Association has no objection to speculative activities being regarded as a disqualification for direct relationship with the Reserve Bank but is not willing to give up dealing in gold and silver ornaments and silver utensils as merchants because the discontinuance of such a lucrative ancestral business would certainly ruin the prestige of the indigenous banker in his locality. It is also opposed to the publication of returns as prescribed for banking companies by the Companies Act because in its opinion such publicity is bound to do them more harm than good although its members would always be prepared to supply necessary information if and when required by the Reserve Bank.<sup>1</sup>

**Joint Stock Banks.** Under this heading are included all the banks registered under the Indian Companies Act. Their foundation was laid in the eighteenth century when the Hindustan Bank

<sup>1</sup> For a stricter opposition of the scheme read Appendix C, *Statutory Report of the Reserve Bank*, pp. 68-71.

was established in 1770. The early joint-stock banks were all under European control and management but during the past thirty years or so<sup>1</sup> many purely Indian banks have sprung into existence assisted by the Swadeshi Movement of 1905 and by the high tide of economic revival which swept over the country during the post-War period. The Bank of India and the Indian Specie Bank were established in Bombay in 1908 and were followed by a perfect stream of new floatations. Many of the new banks confined themselves to legitimate banking business but a large number engaged in other business in addition and could hardly be called Banks. They made rapid progress before the War but unfortunately many of them were swallowed up by the banking crisis of 1913 which gave a great set-back to Indian banking.<sup>2</sup> The crisis was caused by the fraudulent dealings of selfish and incapable directors who frequently combined trading with banking and offered unusually high rates of interest to depositors. "There was want of co-operation and co-ordination between the Indian banks themselves, the attitude of the English and Presidency Banks was unsympathetic and hostile and even the Government was indifferent spectator if not averse to their existence and prosperity."<sup>3</sup> The first important failure to take place was that of the Peoples Bank of India and the loss of confidence caused by the failure of the Bank resulted in a very large number of other failures, the principal being that of the Indian Specie Bank. Since those events,

1 Really speaking, the first purely Indian joint stock bank—the Oudh Commercial Bank—was started in 1881 followed by the Punjab National Bank in 1894 and the Peoples Bank of India in 1901.

2 During 1913-14, over 100 banks registered under the Indian Companies Act with total subscribed and paid-up capital of about Rs. 15½ and Rs. 6½ crores respectively, failed.

3 Thakur—*Organisation Indian Banking*—p. 33.



confidence was largely restored. But in April 1923 the Alliance Bank of Simla failed. The effects of the failure of this old established bank might have been disastrous but for the prompt action of the Imperial Bank which dealt with the situation in close association with the Government of India. The Imperial Bank undertook to pay the depositors of the Alliance Bank 50 per cent of the amounts due to them. A failure was averted and a critical period passed through with little difficulty. During 1923, the Tata Industrial Bank, which was established in 1918, was merged in the Central Bank of India.

In 1932, there was another crop of bank failures. Altogether 23 banks closed their doors, Madras heading the list with 9, Bengal following with 4, Bombay, United Provinces, Punjab, Bihar and Orrisa accounting for two each and Mysore and Travancore for one each.

The end of June 1938 witnessed a banking crisis in South India in the failure of the Travancore National and Quilon Bank Limited. The bank held a very important position among the South Indian joint stock banks. It had a paid-up capital of Rs. 25 lakhs and had 78 branches. As soon as the news of the failure were received, the Reserve Bank sanctioned special credit limits to banks in South India and these limits were later doubled. But for this timely action of the Reserve Bank a major banking crisis would have been precipitated.

At present there are 84 such banks, mostly scattered over big commercial areas. The following table shows the progress that they have made in recent years.

## CLASS A.

*(with capital of over 5 lakhs of rupees)*

Year.	Number of banks	Capital and Reserve. (In lakhs of Rs.)	Deposits (In lakhs of Rs.)	Cash Balances (In lakhs of Rs.)
1913	18	3,64	22,59	4,00
1923	26	9,73	44,43	7,37
1924	29	10,71	52,50	11,30
1925	28	10,60	54,49	10,10
1926	28	10,84	59,68	9,12
1927	29	11,08	60,84	7,70
1928	28	11,10	63,85	8,19
1929	23	11,54	62,72	9,05
1930	30	11,85	63,22	7,67
1931	33	12,03	62,23	7,69
1932	34	12,21	72,34	9,76

## CLASS B.

*(with capital of over 1 lakh and under 5 lakhs of rupees)*

Year	Number of banks	Capital and Reserve (In lakhs of Rs.)	Deposits (In lakhs of Rs.)	Cash balances. (In lakhs of Rs.)
1913	23	50	1,51	25
1923	43	1,11	3,26	61
1924	41	1,08	2,69	35
1925	46	1,18	3,42	68
1926	47	1,26	3,47	82
1927	48	1,22	3,46	52
1928	46	1,20	3,50	52
1929	45	1,15	3,58	45
1930	54	1,37	4,31	52
1931	51	1,24	3,84	47
1932	49	1,21	3,82	65

The business of the joint stock banks consists in receiving deposits of all kinds—current, saving and fixed—and in advancing loans against bills of exchange and imomovable security in towns and against grain, cotton, piece-goods etc., in the villages. They do not rediscount their bills nor do they do the business of bank acceptances but they freely undertake agency and safe custody work. They transfer money from one place to another and buy and sell shares on behalf of their clients. Owing to the competition of non-Indian exchange banks and the small margin of profit realised on foreign exchange business, the Indian bankers prefer to employ their capital in internal

business of a more profitable character. Hence, they “practically take no part in the financing of India’s foreign trade from the stage at which exports leave her ports or to the stage at which imports arrive thereat”.<sup>1</sup> Loans are given for short periods and against certain forms of security only. The result is that they do not take any material part in the financing of industries, unlike the German or Continental banks in Europe. Nor do they have any direct relations with the agriculturists in the marketing of staple produce. Except for certain parts of Southern India, their role in rural credit is usually that of an intermediary furnishing part of the credit to the indigeneous bankers and in a small degree to the landlord or the co-operative banks. They are admittedly in the best position to finance the movement and marketing of crops by making short-term advances against produce and “in order that they may be able to do so the arrangements for the marketing of crops must be improved by (a) the grading and standardisation of staple and of contracts, (b) proper storage facilities, and (c) the creation of properly regulated local as well as forward markets. Regulation of markets is necessary by the enactment of special marketing acts which will provide for the licensing of brokers, the conditions of their business, settlement of disputes, use of standard weights and measures, prohibition of illegal deductions, publication of marketing information and construction of warehouses.”<sup>2</sup>

The Indian Commercial Banks are smaller as compared to similar banks in other progressive countries and fail to inspire greater public confidence owing to the practice of keeping dangerously

<sup>1</sup> *Central Banking Enquiry Committee Report*—p. 374. Also read p. 312.

<sup>2</sup> *Statutory Report of the Reserve Bank of India* published under Section 55 (1) of the Reserve Bank of India Act, in 1937—p. 8.

low cash balances, especially by the smaller banks, as the following table will show :—

JOINT STOCK BANKS  
*Percentage of Cash to Liabilities*

	1910 %	1913 %	1917 %	1920 %	1923 %	1925 %	1927 %	1929 %	1931 %	1932 %
<b>Class A.</b> Banks with Capital and Reserve of over 5 lakhs.	12	18	25	23	17	19	13	14	12	13
<b>Class B.</b> Banks with Capital and Reserve between 1 and 5 lakhs.	—	16	21	18	19	20	15	13	12	17

It is quite obvious, therefore, that they have not benefited by the sinister experience of the pre-War period and that there is an urgent necessity of prescribing a definite minimum percentage of cash reserves to liabilities.

The existing banks require consolidation rather than expansion. "In a large country like India it is preferable for joint stock banking to expand by means of new branches of existing banks rather than by more new banks. The former course has the advantage of dividing the risk of the parent banks over a number of branches and overcoming the effects of local crisis much better than would be the case with small independent institutions. The opening of new branches would, on the whole, lead to an increase in business and in prestige."<sup>1</sup>

**Foreign Exchange Banks.**<sup>3</sup> They have their

1 L. C. Jain—*The Monetary Problems of India*—p. 193.

2 The name is a misnomer. Joint stock banks are allowed to undertake foreign exchange business and the foreign exchange banks are also joint stock banks.

headquarters in foreign countries and are, therefore, not registered in India. Although they do not publish any statement relating to their Indian business separately, it is an open secret that their Indian business is only a small percentage of their total business which is undoubtedly stupendous. Two<sup>1</sup> of them are mainly concerned with tourist traffic while the rest (16) perform more or less the same functions as the Indian joint stock banks. Their chief importance lies in financing India's foreign trade which the purely Indian banks are unable to do. This is done by drawing funds from foreign countries<sup>2</sup> and investing them in the purchase of bills drawn against imports and exports to and from India. The financing of the import trade is for the most part done by branches outside India, the Indian branches' share in the business consisting principally in collecting the amount of the bills at maturity and in furnishing their other branches with the information as to the means and standing of the drawers of the bills. It is as regards the export business that the Indian branches are more immediately concerned. The Exchange Banks have practically a monopoly of the export finance in India. The bills against exports are largely drawn at three months' sight and may either be "clear" or be accompanied by the documents relating to the goods in respect of which they are drawn. Most of them are drawn on well-known firms at home and are easily discounted in London. Bills

1 Messrs. Thomas Cook and Sons and American Express Company.

2 At one time the Banks carried on their operations in India almost entirely with money borrowed elsewhere, principally in London—the home offices of the Banks attracting deposits for use in India by offering rates of interest much higher than the English banks were able to quote. Within recent years, however, it has been discovered that it is possible to attract deposits in India on quite as favourable terms as can be done in London and a very large proportion of the financing done by the Exchange Banks is now carried through by means of money borrowed in India.

purchased in India are sent home by the first possible mail so that, presuming they are rediscounted as soon as they reach London, the exchange banks are able to secure the return of their money in about 16 or 17 days instead of having to wait for three months which would be the case if they were unable to rediscount. In this way the exchange banks are able to limit the employment of their own resources to a comparatively small figure in relation to the business they actually put through.<sup>1</sup> They also help the foreign trade of the country by making loans against shipping and other documents and by issuing foreign letters of credit. They also finance imports of bullion and keep the traders in distant places informed about their mutual financial position from time to time—a facility very essential for safe and prosperous international trade.

As the exchange banks are controlled and financed by foreigners, it may be argued that the share of the Indians in the foreign trade of their country is negligibly small (less than 15 per cent of the total). Other incidental losses have also to be reckoned in. There is reason to fear that branches of exchange banks, even when they are opened at the request of Indian clients, encroach on the financing of domestic trade as well. The cheap deposits raised by exchange banks place them in a strong competitive condition which is further reinforced by the natural tendency on the part of their customers to open and keep accounts with them. Besides, exchange banks have been accused of compelling Indians to insure their goods with foreign insurance companies on the usual grounds, which however plausible on their face, cannot but limit the growth

1 For the exact mechanism of foreign trade and finance, read *Central Banking Enquiry Committee Report*-pp. 314-320, and Muranjan, *Modern Banking in India*, pp. 165-170.

of Indian enterprize in this field.<sup>1</sup> This involves the loss to India of a large amount in the shape of commission, brokerage, and insurance paid to non-Indians. Moreover, Indians, as a matter of rule, are not employed to posts of trust and responsibility. The Central Banking Committee, therefore, recommended that all non-Indian banks wishing to do banking business in India should be required to take out a licence from the Reserve Bank and should be required to train and employ as many Indians for executive posts as may be found suitable. They have also advised that, after the establishment of the Reserve Bank, the Imperial Bank may be allowed to take to foreign exchange business or, in the alternative, that a purely Indian exchange bank should be set up with the support of the Government and the Reserve Bank.

The following table illustrates the progress of the exchange banks since the last War :—

Year	Number of Banks	Capital and Reserve.	Deposits in India.	Cash Balances in India.
		(£ 1,000)	(£ 1,000)	(£ 1,000)
1913	12	37,825	23,276	4,411
1919	11	53,070	55,769	22,487
1920	15	90,217	56,105	18,881
1921	17	111,632	56,397	17,675
1922	18	112,221	55,038	12,132
1923	18	140,103	51,332	10,859
1924	18	130,464	52,976	12,275
1925	18	138,311	52,909	7,062
1926	18	148,003	53,658	8,046
1927	18	180,919	51,647	6,098
1928	18	187,923	53,354	6,042
1929	18	227,625	49,994	6,785
1930	18	193,616	51,086	5,782

It is quite clear that while the number of banks since 1922 has remained constant at 18, their capital

1 Muranjan—*Modern Banking in India*—p. 166.

and reserve have shown almost continuous progress. The Indian deposits, which compare favourably with the deposits of the joint stock banks, have tended to decrease while the cash balances in India have fallen from over £22 millions in 1919 to less than £6 millions (that is, one-fourth) in 1930.

The table below gives an idea of the percentage of cash to liabilities maintained by these institutions during the last twenty years :—

#### FOREIGN EXCHANGE BANKS.

*Percentage of Cash to Liabilities on Deposits in India.*

	1910 %	1913 %	1914 %	1920 %	1923 %	1925 %	1926 %	1928 %	1930 %	1932 %
A—Exchange Banks. <sup>1</sup>	16	19	40	30	19	13	14	11	11	13
B—Exchange Banks <sup>2</sup>	21	17	160	58	27	15	17	11	11	13

The gradual reduction in the proportion of cash to liabilities gives legitimate cause for alarm.<sup>3</sup> A

1 Doing considerable portion of their business in India.

2 Agencies of large banks doing business all over Asia.

3 Compare in this connection conditions prevailing in other countries.

*Percentage of cash and other items of cash nature to total deposits.*

Country	1929	1930	1931	1932	1933	1934
France ...	15·8	18·8	29·8	25·9	21·0	—
Germany ...	4·6	5·1	5·8	5·4	—	—
England and Wales ...	25·2	23·9	22·9	21·7	22·0	—
Canada ...	17·2	16·7	15·0	15·3	14·7	16·1
United States ...	13·0	16·2	15·3	14·0	16·1	—
Australia ...	14·6	20·7	18·3	15·4	18·3	—
New Zealand ...	12·9	13·6	12·4	7·5	8·6	—

*See Commercial Banks—1929-31—pp. XLIII—XLIV.*



proportion which may be considered adequate in a country like England with a highly developed banking organisation and accustomed to the use of cheques, may be regarded as inadequate in a country like India. "An Indian Reserve, such as they appear to keep, of from 18 to 20 per cent, would be respectable, for example, in England. But in such a country as India where banking is ill-established and hoarding more than a memory, the proportion held in reserve seems somewhat lower than perhaps it ought to be. Possibly, exchange banks have already been in smooth waters longer than is for their goods."<sup>1</sup> Now, that the proportion is even less—11 to 13 per cent—it is extremely necessary that the exchange banks should be compelled by law to maintain a fixed minimum percentage of cash balance to their total deposits in India and should not be allowed to disturb the statutory proportion by events affecting their position outside of India.

**The Presidency Banks.** We have already hinted<sup>2</sup> at the establishment of the three Presidency Banks in the nineteenth century. They were private institutions but, in lieu of the capital subscribed by the East India Company and the monopoly of Government banking including the privilege of note-issue entrusted to them, the Secretary and Treasurer of the banks were appointed by the Government. The Government also imposed severe restrictions<sup>3</sup> upon their business, *e. g.* they were not allowed to deal in foreign exchanges or to raise funds outside India. They were not allowed to give loans for a period longer than six months or to make advances on the security of immovable property or upon promissory notes unless they bore

1 Keynes—*Indian Currency and Finance*—p. 216.

2 Chapter XIV.

3 These restrictions added to the safety of the Banks especially at a time when the country was faced with banking crises.

the endorsement of two independent names. They could not give loans upon the security of goods unless either the goods themselves or titles to them were deposited with them as security. The power of note-issue was taken away from them in 1862 and the Government balances withdrawn in 1876 to be put in a separate reserve maintained by the Government and called the Independent Treasury System. Although the banks continued to receive deposits, discount inland bills and manage the public debt of India, it was realised that their popularity was confined to the presidency towns or, at the most, few commercial centres in their respective territories and that there was no co-ordination between them at all. They were reluctant to start branches except in places where they were certain to be profitable. They did not possess sufficient funds for financing the trade of the country. Bills that had been discounted in India had to be re-discounted in London which was not often practicable. There was thus stringency of money in the busy season and redundancy in the slack season causing violent fluctuations in the rates of interest and discount called the *peaks* and *troughs*. The Government controlled currency by its monopoly of note-issue while the credit was controlled, if it was controlled at all, by the Presidency Banks and there was no connection between the two. The Government maintained their own Independent Treasury.<sup>1</sup> The surplus of Government revenues was locked up at headquarters where it was allowed to rot especially at a time when its presence was most keenly felt in the market. The Government were reluctant to make these funds available to the Presidency Banks for the simple reason that they did not wish to entrust public money to private institutions and to create a false sense of confidence in the Government.

1 The system was abolished in 1921.

In short, as Mr. Keynes put it, with no central reserve, no elasticity of credit currency, hardly a re-discount market, and hardly a bank rate policy with the growth of small and daring banks, great increase of deposits, and community not habituated to banking and ready, at the least alarm, to revert to hoarding even when it was seemingly abandoned there were to be found most elements of weakness and few elements of strength."

**The Imperial Bank.** In order to extend banking facilities and to bring about a better understanding between the different members of the money market, many schemes for the establishment of a Central Bank were put forward but the idea did not materialise until the three Presidency Banks were amalgamated into the Imperial Banks in 1921. The capital of the Imperial Bank is Rs. 11.25 crores divided into shares of Rs. 500 each. The paid-up capital and reserve on the 31st December, 1934, were Rs. 5.62 crores and Rs. 5.35 crores respectively. Its governing body, which is responsible for general superintendence and control of Bank's affairs, is called the Central Board. There are three other Boards at Bengal, Bombay and Madras which are known as Local Boards. They are elected by the share-holders and carry out the policy of the Central Board in the light of conditions prevailing in their respective territories. The Central Board of Directors consists of :—

- (a) the Presidents, Vice-Presidents and the Secretaries of the Local Boards ;
- (b) one person elected from amongst the members of each Local Board ;
- (c) a Managing Director and a Deputy Managing Director appointed by the Central Board ; and

(d) not more than two non-officials nominated by the Governor-General-in-Council.

Representatives of any new Local Board which may be constituted may be added at the discretion of the Central Board. The Deputy Managing Director and the Secretaries of the Local Boards are entitled to attend the meetings of the Central Board but are not entitled to vote. The Deputy Managing Director is entitled to vote in the absence of the Managing Director. The Governor-General-in-Council nominates an official to attend the meetings of the Central Board but he is not entitled to vote.

The Bank, until recently,<sup>1</sup> enjoyed Government balances free of interest and acted as a Government banker in all other respects, *viz* : remittance of funds on behalf of and advancing loans to the Government and management of Public Debt. It also exercised certain central banking functions. Thus it held deposits for other banks which regarded them as part of their cash balances and made advances to other banks under certain conditions. "The presence of a bank whose presence and stability were beyond all doubt and which could keep their cash balances was expected to have a very uplifting effect on local banks."<sup>2</sup> The bulk of its business was, however, transacted with private customers. The bank was not allowed to make loans for a period exceeding six months and was debarred from making advances on the security of immovable property. The Bank has an office in London but it was not permitted to deal in foreign exchange except on behalf of the Government. The Bank was not authorised to borrow or receive deposits payable outside India or to maintain a foreign branch for these purposes.

<sup>1</sup> Till the creation of the *Reserve Bank* in April 1935.

<sup>2</sup> Muranjan — *Modern Banking in India*, p. 78.

It was thus a purely commercial bank with private share-holders raised to the doubtful status of a central bank by the Government. The situation was by no means satisfactory and steps had to be taken to replace it by a full-fledged central bank in April, 1935. Needless to say that most of the restrictions under which the Imperial Bank laboured have since been withdrawn.<sup>1</sup> Its Central Board has been re-constituted so as to relax Government control. It has ceased to be the banker of the Government except in places where the Reserve Bank will have no branches. It has been freed from the previous sanction of the Governor-General to establish Local Head Offices and Local Boards and has been fully empowered to shape its financial policy. Many other restrictions have also been withdrawn. For example, the Bank may now open branches, buy and sell bills of exchange not exceeding 9 months if they relate to the financing of seasonal agricultural operations, borrow money and accept deposits from outside India, make advances against goods hypothecated to it and make advances and open cash credits on the security of approved shares, securities and debentures. The Bank will thus have a free hand for financing trade and commerce. But it will continue to occupy a privileged position as the sole agent of the Reserve Bank which is not fair to other banks.

During its 20 years of successful career, the Imperial Bank has rendered useful service to the country. It has started 161<sup>2</sup> branches 26 of which are situated in places where banking facilities were

1 Vide The Imperial Bank Amendment Act of 1934.

2 The Presidency Banks before amalgamation had 54 branches. The Imperial Bank was required to open, within 5 years of its establishment, 100 new branches of which one-fourth were to be at places directed by the Governor-General-in-Council. "To no part of the Imperial Bank Act of 1921 did public opinion attach greater importance than this undertaking to extend banking facilities." Muranjan—*Modern Banking in India*, p. 78.

practically unknown before. With the help of Government balances entrusted to it, it has been enabled to re-discount inland bills on behalf of approved firms and to give loans against promissory notes and over-drafts etc. It has also given the public every facility for remitting money between its branches at reasonable rates. The great differences which existed between the Hundi and Bazar Rates have now been reduced and huge divergences between Madras, Calcutta and Bombay money rates have been equalised to a great extent. The Bank has helped a number of banks in times of crisis, *e.g.*, the Alliance Bank of Simla, and has cultivated relations with Provincial Co-operative Banks by allowing them the advantage of over-draft system. Nevertheless, its business and public usefulness have not grown at the rate expected by the public. The deposits have *decreased* from Rs. 87 crores in 1920 to Rs. 74 crores in 1934 inspite of its reputation as an *Imperial Bank* and its numerous branches. It has not been allowed to take any part in financing the foreign trade of the country which has been attributed to a desire to protect the foreign exchange banks who have established a lucrative monopoly in this country. Even regarding the provision of finance to industries and agriculture it has not been able to fulfil the high expectations made in the beginning. With the help of free Government money averaging about Rs. 20 crores<sup>1</sup> it has

1

IMPERIAL BANK  
Government Deposits

(Lakhs of Rs.)

Year	Deposits	Year	Deposits
1921	22.20	1930	13.91
1926	32.54	1931	15.96
1927	10.04	1932	19.08
1928	7.96	1933	5.82
1929	20.74	1934	7.91

competed with rather than helped other members of the money market and they have made no secret of their resentment against the partial attitude of the Government. The Bank is managed mainly by non-Indians who are less accommodating to their native clients presumably because they do not get sufficient opportunities of knowing much about their credit and character.<sup>1</sup> Allegations of discrimination as against different classes of customers, industries and places were made and fully substantiated by witnesses before the Banking Enquiry Committee. It has not given sufficient opportunities for training Indian apprentices or to appoint Indians to superior posts of trust and responsibility. It was not allowed to issue notes with the result that the gulf between credit and currency policies remained as wide as ever.

**Co-operative Banks.** Whether in urban or in rural areas, a Co-operative Bank means a small society or a credit institution for providing financial accommodation to its members on a co-operative basis. These banks in India are established under the Co-operative Societies Acts of 1904 and 1912. Their origin may be attributed to a desire on the part of the Government to protect the poor agriculturists against the exploitation of the money-lenders and to provide them with necessary credit at reasonable rates of interest. They also aim at educating the poor in the principles and practice of co-operation and thrift.<sup>2</sup>

1 For further indictment of the Bank on this point read Mr. T. Goswami's Minute appended to the *Report of the External Capital Committee*, p. 24 and the *Minority Report of the Indian Banking Enquiry Committee*—pp. 263-265.

2 Which are:—"That an isolated and powerless individual can, by association with others and by moral development and mutual support, obtain, in his own degree, the material advantages available  
(Contd. on page 275)

"The main results achieved may be said to be the provision of a large amount of capital at reasonable rate of interest and the organisation of a system of rural credit which, carefully fostered, may yet relieve the cultivator of that burden of usury which he has borne so patiently throughout the ages. Knowledge of the co-operative system is now widespread; thrift is being encouraged; training in the handling of money and in elementary banking practice is being given."<sup>1</sup> Co-operative Banks have also been established in urban areas where they are rendering useful service to the middle classes in general and to small traders and craftsmen in particular.

The original idea of co-operative credit lies in making available to the needy the surplus of the well-to-do through the medium of the society but in Indian villages the well-to-do and the needy form rather distinct groups—the former dominating and exploiting the latter. Thus, instead of comprising more or less all sections of the population, the societies are often made up of the needy section only, at any rate, very largely. Even otherwise, the slender savings of the well-to-do would not be enough to meet the wants of the needy and each society is not, therefore, able to be self-sufficient, making available the deposits of its wealthy members for the benefit of their less fortunate brethren. Hence funds have to be raised from outside. The structure of co-operative credit consists of the Provincial

<sup>1</sup> Report of the Royal Commission on Agriculture in India, pp. 447.

( *Contd. from page 274* )

to wealthy or powerful persons and thereby develop himself to the fullest extent of his natural abilities. By the union of forces material advancement is secured and by united action self-reliance is fostered, and it is from the interaction of these influences that it is hoped to attain the effective realisation of the higher and more prosperous standard of life which has been characterised as "better business, better farming and better living."—*Maclagan Committee Report*—para 2.



Banks at the apex, the Central Banks which are affiliated to the Provincial Banks, and the Primary Societies which are mostly affiliated to the Co-operative Central Banks.

The Primary Societies form the basis of the financial structure. They are associations of borrowers and non-borrowers—all residents of one locality mostly shaped on the principle of unlimited liability. The knowledge that the members are severally and collectively responsible for the debts of the society makes them vigilant and serves to protect the creditors. They raise their funds from among their members in the form of entrance fees, share capital and deposits. In some provinces *e.g.*, the Punjab, the United Provinces, Madras and Burma, share capital plays an important part whereas in other provinces the share and non-share societies exist side by side. The Central Banking Committee are of the opinion that “the encouragement of subscription to share capital by members as a method of collection of saving is to be preferred to a system of compulsory deposits.” Additional funds are raised from outside public as deposits and from the Co-operative Central Banks to whom they are affiliated. The societies lend money to their members only. Most of their work is done through agencies of an honorary character. Low dividends and voluntary services result in low cost of management and enable the societies to carry a substantial portion of the profits to the reserve fund which is a good safeguard against unforeseen losses and bad debts.

The Central Banks are federations of primary societies in specified areas and are usually located in an important town of each district. Membership is open to private individuals also. They finance

primary societies and guide and co-ordinate their activities. In addition to their own capital, they collect money from the public in the form of deposits and from the Provincial Banks for the use of Primary Societies. "There has been a considerable increase in the number of societies affiliated to some of the central banks; there is one bank which deals with as many as 680 societies. Where such expansion has taken place the work has become unwieldy and the co-operative character of the bank tends to become slender. In such cases even if the central bank is to be retained it seems necessary that societies should be grouped into banking unions."<sup>1</sup>

The Provincial Banks are likewise federations of Central Banks of a Province. They obtain their finance mainly from deposits from the public, from joint stock banks and from the Reserve Bank if necessary. They finance the Central Banks and act as *balancing* centres to them. The Indian Provincial Co-operative Banks Association co-ordinates their activities and supplies information to them about the financial requirements of banks. "As a Provincial Bank is virtually in the position of a Reserve Bank in that province it should give a correct lead to the other co-operative banks on banking and financial matters. It should serve as a development department for the co-operative movement and should take an active part in helping primary units to broaden their basis in the reorganisation of the movement and in the extension of principles of co-operation to other spheres. By interesting themselves in all activities calculated

1 *Statutory Report of the Reserve Bank*, pp. 19-20.

to tone up, consolidate and expand the movement, the provincial banks will make themselves far more useful than if they restrict their role to finance only.”<sup>1</sup>

One more part in the structure of co-operative credit which seems to be eminently desirable is an Apex All-India Co-operative Bank to serve as a central bank to all the co-operative credit institutions of the country. So far, however, such an All-India Bank has not been started but it is hoped that, with an increase in co-operative business, the establishment of the Apex Bank will not be long delayed.

It will be realised that the Co-operative Credit Movement aims at mobilising money from all the possible sources for the benefit of the Primary Societies. Its benefits are, therefore, practically restricted to members only. There are at present (1932-33) 88,705 societies of all descriptions in British India for a population of 269.5 millions which means about 33 societies per 100,000 inhabitants. The Native States claim 16,557 societies for a population of 38.8 millions which works out at 42.6 societies per 100,000 people. Corresponding figures for the whole of India are 105,262 societies for a population of 308.3 millions or about 34 societies per 100,000 people. They claim over 4 million members with a working capital of over 115 crores of rupees which works out at 49 annas per head of population. Other

1 *Statutory Report of the Reserve Bank*, p. 20.

relevant figures relating to co-operation in India are given below :—

	Number of Societies.	Number of Members.	Working Capital.
<i>Agricultural Societies.</i>			
British India ...	78,004	2,577,850	30,96,57,601
Native States ...	14,499	460,750	3,42,16,858
Total ...	92,503	3,038,600	34,38,74,469
<i>Non-Agricultural Societies.</i>			
British India ...	8,388	1,038,361	16,45,30,960
Native States ...	1,924	195,734	3,07,85,108
Total ...	10,912	1,234,095	18,53,16,068
Grand Total ...	103,415	4,272,695	52,91,90,527
<i>Provincial Banks</i>			
British India ...	8	18,750	10,65,98,150
Native States ...	2	1,697	84,15,537
Total ...	10	20,447	11,50,13,707
<i>Central Banks</i>			
British India ...	495	153,493	28,66,02,744
Native States ...	99	26,473	2,75,80,612
Total ...	597	179,966	31,41,83,356
<i>Supervising and Guarantcing Unions</i>			
... ..	988	37,190	20,03,11,038
Grand Total ...	105,100 <sup>1</sup>	45,10,298	115,86,98,628

These imposing array of figures, however, do not reveal the real state of affairs and a closer scrutiny shows that the position is far from satisfactory. One-third of agricultural societies are classified as D or E which means that they were not working properly or were on the verge of liquidation.

On the familiar assumption that a rural family consists of 5 members on the average, the membership of 4 millions means that about 20 million people in India have been touched by the Co-operative Credit Movement. Considering, however,

1 Excluding Insurance Societies.

that 224 millions of persons, representing 71 per cent of Indian population, are supported by agriculture and that rural indebtedness is about Rs. 600 crores, the Movement does not appear to have done much to ameliorate the economic distress of the masses. Its progress has also been retarded for want of proper understanding of co-operative principles. For instance the members do not take much interest in the working of societies which are virtually controlled and administered by officials. The number of defunct, cancelled and under liquidation societies is on an increase every year and those which are working are not doing large business on account of frozen assets. Loans given to members are generally inadequate and are recovered with great difficulty. Partiality and nepotism destroy the loyalty of members and high rates of interest often compel them to knock at the door of the *sahukar*. Moreover, "the fundamental principle of true co-operation is lacking. Overdues are highly excessive. Audit is defective. Control is inefficient."<sup>1</sup> No wonder, therefore, that the village money-lender is still the principal source of finance for the rural population.<sup>2</sup>

Another cause of the failure of the co-operative movement is the failure to realise that credit organisations alone can never provide an effective remedy for the indebtedness of the cultivator. His position can only be improved if the full force of the co-operative movement is brought to bear on him at every point in the sphere of education, of better living, of better farming and of marketing.

1 Evidence of the Managing Governor of the Imperial Bank before the Central Banking Enquiry Committee.

Also read pages 136-140 *C. B. E. C. R.*

2 For a more critical analysis of the present position and suggestions for reform read the *Statutory Report* of the Reserve Bank, pp. 21-28.

**Land Mortgage Banks.** The co-operative societies give loans for short periods only but the agriculturists also require money both for the purpose of redeeming their past debts and for improving their lands which they cannot normally repay in a short period. Hence, the problem of long-term credit is of equally great importance especially to the land-holding classes. This problem is attempted to be solved through Land Mortgage Banks. These banks are generally of three kinds—"The strictly co-operative is an association of borrowers who raise credit by the issue of mortgage bonds bearing interest and made payable to bearer and is well-illustrated in the German *Landschaften*. The commercial type is represented by the *Credit Foncier* of France which works for profit and declares dividends. The third type—the quasi-co-operative, has a mixed membership of borrowers and non-borrowers, operating over fairly large areas and formed with share capital and on a limited liability basis." The commercial land mortgage banks may perhaps be better suited to financing big landlords or *Zemindars*. So far as relief to small agriculturists and owners of small holdings is concerned, the co-operative type is the most suitable. The poor ryots with small holdings cannot secure credit except through organisations based on mutual association and guarantee, and the co-operative land mortgage bank is a legitimate application of that principle. The Indian banks are organised on the co-operative principle although, strictly speaking, they are quasi-co-operative in character. They are conceived as limited liability associations of borrowers with a few non-borrowing individuals thrown in for attracting initial capital as well as the business talent and organising capacity needed to make the management efficient.<sup>1</sup> As these banks require large sums of money for long

1 Central Banking Enquiry Committee pp. 156.

periods, a part of the capital is raised from the shareholders and the rest is subscribed or guaranteed by the Government. As against ordinary credit societies with unlimited liability where greater emphasis is laid on mutual knowledge of, and control over one another, in the case of Land Mortgage Banks with limited liability, greater care has to be exercised in the selection of directors who should be perfectly business-like and competent to evaluate property and to enforce prompt repayment of loans.

At present there are 10 co-operative land mortgage banks in the Punjab. Two of these operate over whole districts, the rest confine their operations to a single tehsil. Bombay has 14 land mortgage societies which have only recently started their operations. Bengal has 5, Assam has 5 while Madras has 95 primary land mortgage banks and a central land mortgage bank has been started recently. These banks advance loans for the redemption of old debts, improvement of land and methods of cultivation and the purchase of land in special cases. The bulk of the funds of these banks will have to be raised by debentures and for this purpose there will have to be in the Provinces central land mortgage banks as in Bombay and Madras. Government will also have to guarantee interest on debentures.

The operations of the Land Mortgage Banks and Societies in India during 1937-38 were as under<sup>1</sup> :—

Number of banks or societies	...	...	201
Number of members	...	...	62,389
Share capital	...	Rs.	23,62,157
Debentures from the public	...	"	34,04,050
Debentures from the Government	...	"	99,650

1 *India Year Book*, p. 427.

Deposits	...	...	Rs.	5,25,384
Reserve and other funds	...	...	"	3,96,636
Loans	...	...	"	<u>1,90,99,760</u>
Working capitals	...	...	"	2,58,87,637
Loans made to individuals	...	...	"	54,99,027
Loans made to Banks and Societies	...	...	"	14,94,398
Profit	...	...	"	47,098

**Post Office Savings Banks.** These banks have been created to inculcate the habit of thrift among the working classes and the middle and lower sections of the community. Government Savings Banks were established in the Presidency towns between 1833 and 1835. The system was extended to selected district treasuries in 1870. The Post Office Savings Banks, opened in all parts of India in 1882 and 1883, absorbed the district savings banks' business in 1886 and that of the Presidency savings banks in 1896.<sup>1</sup> At present the whole of the business of the savings banks is a branch of postal administration. They provide facilities for saving and investment in four ways viz., (1) by receiving deposits in their savings banks, (2) by issuing Postal Cash Certificates, (3) by purchase and sale of Government securities for the public free of charge, and (4) by offering life-insurance policies to Government servants and to permanent employees of all universities established by Government.<sup>2</sup> They have been extremely popular among the professional classes and the intelligent middle class people. The amount of deposits increased from Rs. 4 crores in 1900 to Rs. 12 crores in 1914. The progress was arrested during the War but the money again started flowing in in 1918-19. On the 31st March 1934, the total of savings deposits with the post offices was over Rs. 522·3 millions. The number of post offices doing savings bank work in that year was 23,700 and the number

1 Findlay Shirras—*Indian Finance and Banking*—p. 380.

2 Jain—*The Monetary Problems of India*, p. 128.



of depositors was over 30 lakhs and average deposit per head was Rs. 170. The Postal Cash Certificates particularly have been instrumental in drawing out a considerable amount of savings of poor people to whom perhaps no other means of investment would have proved attractive. In order to prevent the progress from being inconveniently brisk, the Government have put limits on the deposits that can be made and the balance that can be held by a single depositor which are, at present, Rs. 750 and Rs. 5,000 respectively—the limit of balance in the case of minors being Rs. 1,000 only. These restrictions do not seem to be justified because the existing facilities are by no means excessive. There are, at present, about 12,846 banks scattered over about 500,000 villages, that is, one bank to every 40 villages. "In many cases, nearest post office savings banks are situated at a distance of about 10 or 12 miles from the village which means that the people must walk over 20 miles before they can deposit or withdraw their savings." Comparative statistics of the Postal Savings Banks of other countries<sup>1</sup> show that, notwithstanding the popularity of this form of investment in India, the deposit per head of population is only Rs. 2 which is certainly not very satisfactory.

I STATISTICS RELATING TO POST OFFICE SAVINGS BANK  
DEPOSITS OF THE PRINCIPAL COUNTRIES OF THE WORLD.

Country.			Total Deposits (approximate).	Deposit per head of population (approximate).
			Rs.	Rs.
Canada	...	...	63,000,000	6
India	...	...	511,000,000	2
Italy	...	...	2,676,000,000	62
Japan	...	...	3,832,000,000	47
Newzealand	...	...	700,000,000	456
United Kingdom	...	...	4,380,000,000	98
United States	...	...	3,344,000,000	24

It is, therefore, suggested that the existing restrictions should be relaxed subject to suitable precautions regarding sudden withdrawals. The increase of interest, however, above the rates normally allowed by other banks does not seem to be desirable. People have also urged the adoption of cheques but the Central Banking Enquiry Committee do not favour this proposal on the ground that it would prevent the joint stock banks from opening branches at suitable places and that the Post Office would be unable to find, on its present scale of salaries, trained men who could be trusted with the work. If higher salaries were paid, the operation of the department would become prohibitively costly.<sup>1</sup> In order to meet the grievance that there is, at present, too great a diversion of funds outside the districts, some of the money collected through post offices may be placed at the disposal of co-operative societies or advanced as *takavi* to individuals.<sup>2</sup>

STATISTICS SHOWING THE PROGRESS OF THE POSTAL  
SAVINGS BANKS OF INDIA.

(In lakhs of rupees)

Year	Deposits	With- drawals	Interest	Net increase	Amount outstanding at the end of the year
1925-26	19,05	18,19	73	1,59	27,23
1926-27	20,38	18,89	79	2,28	29,50
1927-28	23,14	20,84	86	3,16	32,66
1928-29	26,24	25,39	97	1,82	34,49
1929-30	26,25	24,63	1,02	2,64	37,13
1930-31	24,36	25,50	1,04	10	37,02
1931-32	27,39	27,29	1,08	1,18	38,20
1932-33	30,96	26,86	1,15	5,25	43,44
1933-34	36,87	29,39	1,28	8,78	52,23
1934-35	38,67	37,26	1,34	2,75	58,30
1935-36	46,33	38,88	1,50	8,95	67,25
1936-37	43,38	37,40	1,45	7,43	74,68
1937-38 <sup>3</sup>	43,27	39,76	1,46	4,97	79,65

1 *Bombay Banking Enquiry Committee Report*, paras. 290-291.

2 *Central Banking Enquiry Committee Report*—p. 380.

3 Excluding Burma which has been separated from India.

Except 1930-31, deposits invariably exceed withdrawals. It is also interesting to note that, although the popularity of the saving banks was not affected by the reduction of the rate of interest from 3 per cent (at which it had stood for 28 years) to  $2\frac{1}{2}$  per cent in November 1933, there has been a noticeable fall in net deposits in recent years possibly owing to a further fall in the rate of interest to 2 per cent with effect from 1st July, 1936. On the whole the net deposits increased by substantial amounts even during the gloomy days of the economic crisis. This indicates that, inspite of the depression, considerable small savings are being accumulated and it undoubtedly lends support to the view that some of the proceeds of hoarded gold are finding their way into investments. Similarly, the value of Postal Cash Certificates has increased from about Rs. 9 crores in 1917-18 to about Rs. 64 crores in 1937-38.

**Deficiencies of the Indian Money Market.<sup>1</sup>** Having explained the structure of the Indian Money Market, it remains for us to examine its deficiencies. In the *first* instance, the growth is not commensurate with the size and natural resources of the country as the following figures will show:—

1 These defects existed before 1935 and many of them have disappeared since. This section has been purposely retained in order to enable a student to appreciate the conditions before and after the inauguration of the Reserve Bank.

## STATISTICS RELATING TO COMMERCIAL BANKS OF THE PRINCIPAL COUNTRIES OF THE WORLD

Country.	Number of Commercial Banks.	Branches and sub-branches of Commercial Banks	Number of Commercial Banks (including branches)	Area served by one bank or branch of a bank.	Number of people served by one bank or branch of a bank.	Paid-up Capital and Reserve of all Commercial Banks	Deposits of all Commercial Banks	Deposit per head of population.	Loans and Advances.
			per sq. mile	sq. mile		Rs. (000,000)	Rs. (000,000)	Rs.	Rs. (000,000)
Australia	10	...	..	978	9,749	796	3,996	604	3,100
Canada	10	3,772	.001	99	19,260	461	6,228	599	3,805
France	8	2,727	.01	500	203,077	916	44,444	108	1,293
Germany	3251	...	.0017	51	17,333	2,381	5,818	88	4,763
Japan	5352	4,311	.018	..	11,781	..	11,305	135	6,546
New Zealand	6	..	.0008	1,478	3,424	163	864	562	525
South Africa	8	671	.13	7	7,582	2,453	1,348	169	623
United Kingdom	33	12,963	.0018	207	320,598	19,216	33,200	746	12,189
United States.	18,0673	969	.0005	17,74	..	2,560	81,994	620	112,000
India	102	..	..	..	..	..	2,384	6	..

1 Based on *Statistisches Jahrbuch* which covers all the commercial banks of the country. Other banks have been excluded for the sake of uniformity.

2 Includes Ordinary or Privately-owned banks only. The total number of banks, including the Ordinary Agricultural and Industrial banks and those controlled by the Government, was 13,953 in 1932.

3 Relate to number of Commercial including National, State (commercial) and private banks and Loan and Trust companies existing in 1932. Owing to the system of licensing introduced in 1933, the number of licensed banks is reported to be only 19,829.

While in the United Kingdom there is one commercial banking office after every 7 square miles and for every 3,424 heads of the population, in India there is one to every 1,775 square miles and for every 329,598 heads of the population. Banks in the villages are conspicuous by their absence and even the urban areas are deprived of modern banking facilities because only 339 out of a total of 2,300 towns possess a bank or a branch or agency of a bank. Such banks as exist are very small as compared to similar institutions of other progressive countries. The deposits of all the commercial banks are only Rs. 228 crores, that is, Rs. 6 per head of the population. This compares very unfavourably with the deposits per head of other countries including other, and perhaps less important, members of the British Empire like Australia, Canada, New Zealand and South Africa. This may be attributed to the inadequacy of facilities for attracting small deposits and to the pernicious habit of hoarding which still persists. *Secondly*, credit has not been thoroughly studied and specialised in all its various forms. There is no industrial bank and the commercial banks often find themselves involved in a type of work foreign to them. "They accept short period deposits only which should be utilised for financing commerce only but, in the absence of regular industrial banks, the ordinary banks are forced to lend to industrial concerns with the result that while the genuine and growing needs of the country are to this extent starved, the banks having neither the inclination nor the time nor knowledge to scrutinise such security as the industries offer, often find themselves involved in transactions of an imprudent character."<sup>1</sup> Similarly, there is no satisfactory banking provision for the financing of one great

1 Wadia and Josi—*Money and Money Market in India*—P. 394.

industry of the country *viz.* agriculture. The cultivator still lives on the mercy of the *sahukar* who continues to lend at a high rate of interest and frequently manages to purchase the produce at low prices. "If the producer has to pay anything from 25 to 100 per cent for his finance, the inducement to produce is wanting; for it means that all he makes over and above his bare living goes to his creditors. The secret of successful industry is to buy your finance cheap and to sell your produce dear. The Indian buys his finance dear and sells his produce cheap. His creditor generally fixes the price of both. The ryot feeds the financier in the fat years and the Government feeds the ryot in the lean. Trade flourishes on the labour of the backward people, for three-fourths of the people of India are unable to pay their debts."<sup>1</sup> *Thirdly*, it will be clear from the above table that branch banking is still in its infancy. Its extension is more a curse rather than a blessing to the rural areas because funds attracted there in the form of deposits are seldom utilised for their own benefit. They are sent out to big commercial towns for financing urban trade and industry. *Fourthly*, the credit system is inelastic for any extra demand for currency is not met by the expansion of banking credit. The Government has a monopoly of silver and paper money but, since it does not keep in direct touch with trade and commerce, it is impossible to put just as much currency in circulation as is required by the market. At any rate, there is no connection between the legal tender currency created by the Government and the credit currency created by the banks in pursuance of trade requirement.<sup>2</sup>

1 Evidence of Sir Daniel Hamilton before the *Chamberlain Commission*, Appendices, Vol. II, p. 524.

2 This defect, it is hoped, would disappear now that the Reserve Bank has seen the light of the day.

That the two may go in opposite directions is amply proved from what happened after the War. The Government began a policy of deflation of currency. During the years 1919 to 1921, more than 34 crores of rupees were withdrawn from circulation, that is, more than 10 per cent of the total volume of currency in active circulation. But deposits stood at about Rs. 226 crores on 31st December 1920, that is, at a much higher figure than on a corresponding date in 1919 and the figure was reduced by Rs. 6 crores only by 31st December 1921. It may be pointed out that the greater portion of the deflation of currency took place in 1920 when the deposit currency instead of contracting was expanding.<sup>1</sup> The Government also controls (or until lately controlled) the money markets by its power of purchasing exchange and of issuing treasury bills. That this was not regarded wholesome is sufficiently borne out by the following statement of the Hilton Young Commission — "The Government controls the currency. The credit situation is controlled, as far as it is controlled at all, by the Imperial Bank. With divided control there is likelihood of divided counsels and failure to co-operate."<sup>2</sup> Another difficulty arising from dual control manifests itself in the separation of banking and currency reserves which narrows down the basis of the credit structure. The currency reserve is itself divided into two parts, one of which—the Gold Standard Reserve—is meant to secure the external convertibility of the rupee and the other—the Paper Currency Reserve—to secure the internal convertibility of notes into rupees. The provision for expanding currency in the busy season is inadequate. The Imperial Bank is allowed to borrow a maximum

1 Vakil and Muranjan—*Currency and Prices in India*—p. 531.

2 See also the report of Foreign Experts appended to the Report of the Central Banking Committee, p. 648.

of Rs. 12 crores from the Controller of Currency with which to discount seasonal bills of exchange but the limit of Rs. 12 crores is very small because it is only about 3 per cent of the total export trade of the country. Hence, dissociation of note-issue from banking, scanty cash balances held by the banks and the restricted use of cheques, all add to the rigidity of the currency system. *Fifthly*, there is a deplorable lack of co-ordination between the different members of the Money Market. "Some of the joint stock banks regard the foreign exchange banks as formidable rivals on account of their large resources and their ability to attract deposits at more favourable rates of interest than the joint stock banks themselves. The penetration of the foreign exchange banks into inland business both at the ports and in the interior is also naturally looked upon by the Indian banks as an encroachment upon the latter's proper field of activity."<sup>1</sup> There is no regular connection between the joint stock banks and the Imperial Bank nor between the co-operative banks and the indigenous bankers and money-lenders. Infact, there is a growing feeling among the joint stock banks and the Imperial Bank that the co-operative banks are beginning to compete with commercial banks and indigenous bankers in forms of banking which are outside co-operation, that is, opening current accounts, purchasing drafts, and selling remittances, etc. The Imperial Bank, which was until lately, the only co-ordinating agency between the component parts of the banking system, was looked upon more as an unfair rival than as a friendly co-adjutor. It has miserably failed to inspire public confidence owing to its policy of racial discrimination and owing to its desire to compete with rather than help the institutions it is supposed

1 *Central Banking Enquiry Committee Report*, p. 394.



to protect. *Sixthly*, with banking system so loosely organised one is not surprised to find that "a call rate<sup>1</sup> of  $\frac{1}{4}$  per cent, a hundi rate<sup>2</sup> of 3 per cent, a bank rate<sup>3</sup> of 4 per cent, a Bombay bazar rate<sup>4</sup> for bills of small traders of  $6\frac{3}{4}$  per cent, and a Calcutta bazar rate for bills of small traders of 10 per cent" can exist simultaneously showing extraordinary sluggishness in the movement of credit between the various markets.<sup>5</sup> It is a well-known fact that if banking is to render effective assistance to production, trade, and commerce it should secure stability in the rate of money, or in other words, in the charge for the use of capital. Violent changes in the rate for money indicate financial instability and cannot help the development of trade

1 The Call Money Rate is the rate for surplus money seeking employment for a very short period, say 24 hours, and repayable at the option of either the lender or the borrower.

2 The Imperial Bank's Hundi Rate is the rate at which the Imperial Bank will discount or re-discount first class three months bills.

3 The Bank Rate is the rate at which the Imperial Bank will ordinarily advance money against Government securities

4 The Bazar Rates are those at which the bills of small traders are discounted by shroffs in different centres.

5 Latest figures of Indian Money Rates confirm this statement.

Month.	Bank Rate.	CALL MONEY RATE.		Imperial Bank Hundi Rate.	BAZAR BILL RATE.	
		Calcutta.	Bombay.		Calcutta.	Bombay.
	Per cent.	Per cent.	Per cent.	Per cent.	Per cent.	Per cent.
April, 1932	6	$3\frac{1}{2}$	$5\frac{1}{2}$	6	7—8	6
Decr, 1932	4	$1\frac{3}{4}$	1	4	6—7	$4\frac{1}{8}$
April, 1933	$3\frac{1}{2}$	$\frac{3}{4}$	2	$3\frac{1}{2}$	6—7	$4\frac{1}{8}$
Decr, 1933	$3\frac{1}{2}$	2	2	$3\frac{1}{2}$	6—7	$2\frac{3}{8}$
March 1934	$3\frac{1}{2}$	$\frac{3}{4}$	$2\frac{1}{2}$	$3\frac{1}{2}$	6—7	6

and industry. That Indian money rates are very unstable can be easily proved by taking the rates of discount of the Imperial Bank for the last few years.

*Bank Rates of the Imperial Bank and the Bank of England compared.*

Month.		1930-31		1931-32		1932-33		1933-34		1934-35	
		Imperial Bank.	Bank of England.	Imperial Bank.	Bank of England.	Imperial Bank.	Bank of England.	Imperial Bank.	Bank of England.	Imperial Bank.	Bank of England.
January	..	6	5	6	3	8	6	4	2	3½	...
February	...	6	4-6	6	3	7	5-6	4	2	3½	...
March	...	6	3-9	7	3	6	4	3½	2	3½	...
April	...	6	3-5	7	3	6	3-3	3½	2	...	...
May	...	6	3	7	2-7	5	2-7	3½	2	...	...
June	...	6	3	6	2-5	5	2-5	3½	2	...	...
July	...	6	3	6	2-8	5	2	3½	2	...	...
August	...	5	3	6	4-5	4	2	3½	2	...	...
September	...	5	3	7	5	4	2	3½	2	...	...
October	...	5	3	8	6	4	2	3½	2	...	...
November	...	5	3	8	6	4	2	3½	2	...	...
December	...	6	3	8	6	4	2	3½	2	...	...

The fluctuations in the case of India are rapid and great and the difference between the lowest and the highest rates are marked. The *seventh* outstanding deficiency of the Indian banking system is the absence of a regular bill market. The banks prefer to lock up their assets in Government securities to investing them in commercial bills because in the absence of regular (licensed) ware-houses the former are much more safe and profitable than the latter. Even when bills are discounted, in the absence of adequate re-discounting facilities, they are held till maturity and credit is consequently restricted. The lack of discounting and re-discounting facilities accounts for the slow growth of trade and commerce of the country. The absence of institutions for imparting expert banking education and of a comprehensive

banking law are also regarded serious drawbacks of Indian banking. It is very strange indeed that while the Government have found it necessary to exercise and retain strict control over Insurance Companies, they remain so pathetically indifferent in the matters of banking—a really more important type of credit institution.

In view of the serious deficiencies of the Indian Money Market mentioned above, viz: undeveloped credit facilities which are mainly restricted to the urban areas, inelasticity of currency due to the separation of credit and currency functions, want of co-ordination especially between the Indian Money Market and the bankers working on European lines, and lack of concentration of reserves in the hands of a central institution, the Hilton Young Commission suggested the immediate establishment of a Central Bank—to be called the Reserve Bank—for India.

**Meaning of a Central Bank.** Now, what is this Central Bank which has been agitating the public mind for over a century? Why has it been regarded such an infallible remedy for the economic ills of a nation? A Central Bank has been described as “the people’s agency to govern their supply of currency and credit, free from any undue influence of politics or profits.”<sup>1</sup> Its principal task consists in maintaining the stability of the value of currency both internally as well as externally

1 L. C. Jain—*A Reserve Bank for India*, p. 1.

and in controlling the credit situation in the country, including the rate of interest, at which credit would be available to trade and industry.<sup>1</sup>

1 "In the statutes of Central Banks adopted before the War, there is generally no mention of the primary functions of a central bank; the preamble or the opening articles usually contain a list of the operations the bank may or may not undertake. In the statutes drafted during the reconstruction period after the War the main object of the bank is specified but this is usually confined to the regulation of the monetary circulation with a view to ensuring the stable gold value of the currency. The definition of the general objective of the central banking system in the recent statutes and amendments is considerably more extensive, though striking differences characterise the formulation of this objective in various countries. Denmark alone affords an example of recent legislation defining the primary function of the central bank in terms similar to those employed in the early post-war period; according to Section I of the Law of April 6th, 1936, amending the statutes of the National Bank, the principal aim of the Bank is to "maintain a safe and secure currency system in this country and to facilitate and regulate the traffic in money and the extension of credit." In the Argentine Law of March 28th 1935, setting up a new central bank, the objective though broadly similar to that stated in the Danish law, is formulated differently; it is stipulated that the Bank should "concentrated sufficient reserves to moderate the consequences of fluctuations in exports and investments of foreign capital on currency, credit and commercial activity, in order to maintain the value of the currency."

"In other countries, this objective is variously defined. Thus the preamble to the Bank of Canada Act of July 1934 stipulates that the chief function of the Bank is "to regulate credit and currency in the best interests of the economic life of the nation, to control and protect the external value of the national monetary unit and to mitigate by its influence fluctuations in the general level of production, trade, prices and employment, so far as may be possible within the scope of monetary action." Similar but more extensive and specific views on desirable objectives for central bank policy are contained in the recommendations of the Report of the Australian Royal Commission on Monetary and Banking Systems. According to this Report, the Commonwealth Bank should in the conduct of its business, make "the reduction of fluctuations in general economic activity in Australia" its chief consideration. "The policy is not to fix the exchange rate and to require the economy in ordinary circumstances to adjust itself to that rate, but to keep the economy reasonably stable and to move the exchange rate, if necessary, as one means to that end." It is further recommended that the Bank should regulate the volume of credit to the banks "so that the latter will be induced to maintain a level of advances and deposits which will best serve the general objective of the Australian economy." It is also added that the Commonwealth Bank should pay "some regard" to the distribution by the banks of the volume of credit among different industries

(Contd. on page 251)

**The Task of a Central Bank.** In order to enable a Central Bank to achieve the above objects, it is entrusted with the following functions :—

1. The Right of Note-issue ;
2. The Right to hold the Reserves of the Commercial Banks ;
3. The Right to Buy and Sell Securities ;
4. The Right to Discount.

The right of note-issue enables the bank to combine functions of currency and credit and thus to regulate the total amount of money in circulation. This is necessary for maintaining the stability of currency both inside and outside the country. As a custodian of the reserves of

and see that the credit provided is made available "at appropriate rates of interest." In this connection, reference may also be made to an interpretation of the objectives of the monetary policy of the Federal Reserve System in the United States contained in a statement of the Board of Governors of August 2nd 1937, where it is declared that "economic stability rather than price stability should be the general objective of the policy of the system, and "that this objective cannot be achieved by monetary policy alone, but that the goal should be sought through co-ordination of monetary and other major policies of the Government which influence business activity including particularly policies with respect to taxation, expenditure, lending, foreign trade, agriculture and labour."

"The definition of the objectives of the Reserve Bank of New Zealand as contained in Section 10 of the Amendment Act, 1936, represent a more striking departure from traditional definitions. The first duty of the Reserve Bank is stated to be as follows: "It shall be the general function of the Reserve Bank, within the limits of its powers, to give effect, as far as may be, to the monetary policy of the Government, as communicated to it from time to time by the Minister of Finance. For this purpose, and to the end that the economic and social welfare of New Zealand may be promoted and maintained, the Bank shall regulate and control credit and currency in New Zealand, the transfer of money to or from New Zealand, and the disposal of moneys that are derived from the sale of any New Zealand products and for the time being are held overseas."—*League of Nations—Monetary Review*, 1937-38.

commercial banks, it can supervise and co-ordinate the activities of all banks in the country and ensure their co-operation at all times. The right to buy and sell securities facilitates open market operations, that is, enables it to expand the volume of currency in circulation by purchasing securities and to contract it by selling securities both to the public and to the member banks. At times credit restrictions are necessary to prevent excessive speculation and other unhealthy symptoms of trade or to correct adverse foreign exchanges. If commercial banks have huge cash resources the Central Bank may find it difficult to prevail upon them to restrict credit. Under such circumstances the Bank can reduce the market supplies of money by selling bills and securities on its own initiative in the open market until the discount rate becomes effective. Thus, with the diminution of the available cash supplies, a policy of credit restriction can be forced on the commercial banks. The Bank can also purchase bills and securities which can increase the cash of the commercial banks and thus a sudden stringency can be relieved at the initiative of the Bank and credit expansion is possible. Open market operations also help the Bank in investing its funds remuneratively under appropriate conditions and safeguards. The control over the discount or rediscount policy assists in regulating the amount of credit and in liquidating the assets of commercial banks. If a commercial bank is prudently managed and is sound, it can get loans from the Central Bank on approved short-term securities and can also get approved commercial paper re-discounted at the Bank. The grant of these facilities is a unique service rendered by Central Banks. The Central Bank's discount rate (or simply, Bank Rate) is also an effective means of stopping the outflow of gold from the

country, for, by raising it, the drawing of finance bills<sup>1</sup> of exchange is discouraged. Moreover, the sale of securities to the commercial banks can be enforced by means of the cash held by them at the Central Bank and by reducing their cash balances with it the Central Bank can compel them to reduce their discounting business and thus to push up the discount rates. High rates of discount tend to curtail credit and *vice versa*. Hence, the normal working of a Central Bank brings about an evenness in monetary conditions.

It will be observed, therefore, that the Central Bank is essentially a Bankers' Bank. Just as credit is given by the ordinary banks to a businessman the Central Bank gives credit to commercial banks by means of re-discounting facilities and its power of note-issue. The Central Bank is thus in a position to control undue expansion of credit and currency in a period of prosperous business activity and to control undue contraction in a period of depression and thus prevents a crisis. It also distributes the total credit of the country among the several industrial and commercial institutions. Some people have emphasised the importance of "moral persuasion" by which the Central Banks often exert much indirect influence over the loan policy of the member banks. There is generally much close co-operation between the Central Bank and the member banks and the former often persuade the latter to follow its lead. Professor Sprague, while recounting the

1 These are fictitious bills drawn against *blank credit*. They are drawn when the rates of interest in different countries are different and it is profitable to raise loans in one country for the purpose of investing them in the other. Also see Evitt—*A Manual of Foreign Exchange*—pp. 83—84.

The Bank Rate can be employed for checking gold export in another way also. A rise in it lessens the demand for loans, checks expenditure in the country and lowers prices. This decreases imports and encourages exports and helps to restore the adverse trade balance which is the primary cause of the foreign demand for gold.

achievements of Central Banks, says—"The special functions of Central Banks may be grouped under three heads. They serve as fiscal agents of governments; they have large powers of control over the currency through the more or less complete monopoly of note-issue; and finally, since they hold a large part of the reserves of other banks, they are directly responsible for the foundation of the entire structure of credit. This last is by far the most important function of Central Banks."<sup>1</sup>

Sir Benjamin Strong, Governor of the Bank of England, in his evidence before the Hilton Young Commission, enumerated the duties and functions of the Central Bank as follows:—"It should have the sole right of note-issue, it should be the channel, and the sole channel, for the output and intake of legal tender currency. It should be the holder of all the Government balances; the holder of the reserve of other banks and branches of banks in the country. It should be the agent, so to speak, through which the financial operations at home and abroad of the Government would be performed. It would further be the duty of a Central Bank to effect, so far as it could, suitable contraction and suitable expansion in addition to aiming generally at stability and to maintain that stability within as well as without. When necessary, it would be the ultimate source from which emergency credit might be obtained in the form of re-discounting of approved bills, or advances on approved short-dated securities or Government paper."

The business of a Central Bank should be conducted on safe lines. Its assets must be liquid and ungrudgingly put at the disposal of approved banks. But direct dealings with trade are generally

<sup>1</sup> See his contribution to *Dunbar's Theory and History of Banking*.



prohibited because this prevents Central Banks from being un-necessarily involved in transactions of a doubtful character. It is also desirable in the interest of avoiding competition and maintaining good relations between the Central Bank and commercial banks affiliated to it.

Such institutions exist in almost every civilised country of the world—Bank of England in England, Bank of France in France, Reichsbank in Germany and the twelve Federal Reserve Banks, operating under the Federal Reserve Board of Washington. Even in India the amalgamation of the three Presidency Banks showed clearly that the people were no longer afraid to “put all their eggs in the same basket.” Unluckily for India, the Imperial Bank was deprived of the power of note-issue which is the *sine qua non* of a modern Banker’s Bank, and by its own sins of omission and commission, it failed to inspire sufficient confidence to be reckoned as such.

The Government introduced the Gold Standard and Reserve Bank of India Bills in the Assembly in 1927 and 1928. The former was approved but the latter raised a tremendous issue over which the whole scheme foundered.

**A State or Share-holders Bank.** In determining the constitution of the Reserve Bank, opinions were divided as to whether it should be managed and owned by the State or it should be floated with the help of capital raised from private share-holders. Those who favoured the State control of the Bank urged that since a wise central banking policy is the basis of a sound national economic life, the Central Bank should be under the control of the Government. Especially in India, which is noted for mass illiteracy and absence of banking habits, only a State Bank can inspire confidence among the people, much more

so if it is made responsible to the Legislature. In case of extreme national emergency, the State can command greater purchasing power through the expansion of note-issue and the suspension of specie payments only if it has an effective control over the administration of the Bank. They also argued that a Central Bank does not require much capital nor a large body of profiteering share-holders. It can, therefore, be freed from the domination of large capitalists in big cities and prevented from degenerating into a dividend-hunting organisation only by transferring control to the State.

Those who favoured the share-holders plan, on the other hand, maintained that if the management of note-issue is entrusted to the State itself, the Government may be tempted to adopt the simple method of raising money which is offered by the power of printing notes. Besides, monetary policy should be independent of political contingencies and the surest way of securing this result is to place control of the note-issue in the hands of a Bank. They also contended that if the Bank is under State control, continuity of policy cannot be guaranteed with changing governments nor can freedom from political bias in its administration be assured.<sup>1</sup> The net work of financial and commercial life is so intricate and the decisions of the Bank on important points have such wide-spread results that all interests are not affected in the same way. If, therefore, there is an independent or

1 "The cases of the Bank of Spain in the latter part of the 19th century and of the Bank of France in recent years can be cited to prove the point. In both cases the Banks acting under Government compulsion exceeded legal limits for advances to the Treasury with the result that the currency depreciated heavily. The financial crisis in France in 1926 was intensified by the depreciation of the franc which was caused by exceeding the legal limit from 41 milliard francs fixed in 1920 to over 3,000 million francs, with the result that the volume of notes in circulation rose to over 43 milliard francs"—Hon. G. Pal, *The Financial Crisis of France*, pp. 230-232, quoted by K. K. Sharma, *Currency and Commerce*.

quasi-independent bank, the Government would find it difficult in practice to suspend the obligation of the Bank except when a true national emergency occurs.

Bearing these facts in mind one is not surprised to learn that even among the recently established or recently re-organised banks there is already a tendency to move away from complete State control. A resolution of the Brussels Conference emphasising that "Banks and especially a Bank of Issue should be freed from political pressure and should be conducted solely on the lines of prudent finance" crystalizes the general feeling on the point. The statutes of the central banks set up or reorganised during the post-War reconstruction period generally contain a clause or a sentence emphasising this independence either as regards ownership or management, but more especially the latter, a notable exception being the statutes of the Bank of Finland. The latter were modelled on the statutes of the Swedish Riksbank and the Bank of Norway and provide for fairly close State supervision and control and for important appointments at the Bank being made by public authorities. A State Bank should be capable of carrying out its task efficiently if the Government and Legislature impose upon themselves a self-denying ordinance limiting their opportunities for intervention but, owing to the inherent weakness of human nature and due to the suspicion with which all state activities are regarded in India, a State Bank does not appear to be advisable.<sup>1</sup> This,

1. "Almost all the Central Banks of the world have been set up on the basis of privately supplied capital and under the management of a Board of Directors who, in their daily administration, are protected against interference on the part of Government or Legislature. The choice of Governors and Deputy Governors is subject to official approval so that the State, as representing the public, may have assurance that the highest administrative offices are properly filled." Sir Cecil Kisch—*Empire Central Banks*—an article in the *Indian Finance Reserve Bank Inauguration Number*.

however, does not rule out the desirability of general superintendence. Governments in most countries have some influence in the matter of the constitution of the governing body of the Central Banks and exercise the right of general supervision and control in the interest of the public.

**The Banking Enquiry Committee.** Being unable to come to an agreement, the Government postponed the question *sine die* and in the meanwhile ordered a comprehensive banking enquiry for the whole of India in 1929 with the following terms of reference:—

“To investigate past records and existing condition of banking in India, including the organisation of the Money Market, and to consider the steps, if any, that are feasible and desirable under the following main headings.—

- “(a) The development of banking with a view to the expansion of indigenous, co-operative and joint stock banking with special reference to the needs of agriculture, commerce and industry;
- “(b) The regulation of banking with a view to protecting the interests of the public; and
- “(c) Banking education with a view to the provision of Indian personnel in

In recent years, the State has assumed partly or wholly the ownership of the central bank in other countries—Canada, Denmark, Italy and New Zealand. The capital of the central bank is owned by the State also in Australia, Finland, Latvia and Sweden. In other countries, the law provides that the State may hold a stated proportion of the central bank's capital—e. g. in Czechoslovakia a third, in Japan half, and in Roumania 10 per cent.

League of Nations—*Monetary Review*, 1937-38, page 81.

adequate numbers and with the necessary qualifications to meet the increasing needs of the country for a sound and well-managed national system of banking."

The Native States were also invited to undertake similar enquiries in their respective territories. The principal recommendations of the Central Banking Enquiry Committee may be briefly summarised as follows :—

1. The establishment of a Central or Reserve Bank for the mobilisation of the banking and currency reserves of India and for increasing the volume of credit available for trade, industry and agriculture.

2. The removal of the restrictions on the foreign exchange business of the Imperial Bank of India as being in the interest of development of India's foreign trade. The creation of a new Exchange Bank in the event of no satisfactory arrangement being made between the proposed Reserve Bank and the Imperial Bank of India regarding the conduct of exchange business if the latter should find itself unable to fulfil its obligations regarding foreign trade within a stipulated period. For the development of the Indian bill market, the Reserve Bank is to be permitted to purchase, sell and re-discount rupee import bills. The formation of an All-India Bankers' Association including as members, not only the three classes of banks, but indigenous banks as well.

3. For the regulation of banking, two principal recommendations are made—(a) The promulgation of a special Bank Act comprising provisions governing all banking institutions, and

(b) the amendment and amplification of the Indian Companies Act so as to provide for additional matters which require to be dealt with by legislation.

4. For the development of banking education, the universities are urged to give greater facilities for the study of banking.

A Bill was accordingly introduced in the Legislative Assembly which after drastic modifications passed into law in 1934.

**Summary of the Reserve Bank of India Act of 1934.** The Act provides for the establishment of a Bank—to be called the Reserve Bank of India—for the purpose of taking over the management of the currency from the Governor-General-in-Council and of carrying on the business of banking as specified in the Act.

*Share Capital, Share Register and Shareholders.* The original share capital of the Bank shall be five crores of rupees divided into fully paid-up shares of one hundred each. Separate registers of share-holders shall be maintained at Bombay, Calcutta, Delhi, Madras and Rangoon and a separate issue of shares shall be made in each of the areas served by those registers. A share-holder shall be qualified to be registered as such in any area in which he is ordinarily resident provided he is domiciled in India and, in the case of a company, provided it is registered in India under the Indian Companies Act, 1913 or under the Co-operative Societies Act, 1912.

*Management.* The general superintendence and direction of the affairs and business of the Bank shall be entrusted to a Central Board

of Directors which shall consist of (a) a Governor and two Deputy Governors to be appointed by the Governor-General-in-Council on the recommendations of the Board, (b) four directors to be nominated by the Governor-General-in-Council, (c) eight directors to be elected on behalf of the share-holders on the various registers, and (d) one Government official to be nominated by the Governor-General-in-Council who may attend any meeting of the Board and take part in its deliberations but who shall not be entitled to vote. The Governor and Deputy Governors shall be whole-time paid servants and shall hold office for such term, not exceeding five years, as the Governor-General-in-Council may fix and shall be eligible for re-appointment. Meetings of the Central Board shall be convened by the Governor at least six times in each year and at least once in each quarter.

There shall be a Local Board for each of the five areas for advising the Central Board on such matters as may be generally or specifically referred to it or to perform such duties as may be delegated by the Central Board. Every Local Board shall consist of (a) five members elected from amongst themselves by the share-holders of each area, and (b) not more than three members nominated by the Central Board from amongst the share-holders of the area, due regard being paid to the representation of share-holders of that area and to the representation of territorial and economic interest—especially the agricultural interests, and the interests of co-operative banks. At an election of members of a Local Board for any area, any share-holder who has been registered on the register of that area for a period of not less than six months ending with the date of election as holding five shares

shall have one vote and each share-holder so registered as having more than five shares shall have one vote for each five shares but subject to a maximum of ten votes. Salaried Government officials, members of the Assembly and Legislative Councils, officers and employees of other banks and insolvents and lunatics are debarred from being directors or members of Local Boards.

*Business which the Bank may transact.* The Bank shall be authorised to transact and carry on the following kinds of business —

- (1) To accept money on deposit without interest from the Government, Native States, local bodies, banks and other persons.
- (2) To purchase, sell and re-discount bills of exchange and promissory notes drawn on and payable in India and arising out of *bona fide* commercial or trade transactions bearing two or more good signatures one of which shall be that of a scheduled bank<sup>1</sup> and maturing within ninety days from the date of such purchase or re-discount, exclusive of days of grace. The Bank is also authorised to purchase, sell and re-discount bills drawn or issued for the purpose of financing seasonal agricultural operations or the marketing of crops maturing within nine months and those issued

1 Approved Banks mentioned in the Second Schedule appended to the Act. Such banks have a minimum capital of Rs. 5 lakhs and are required under Section 42 of the Reserve Bank of India Act to maintain deposits with the Reserve Bank. Section 18 also authorises the Bank to purchase, sell and discount bills of exchange and promissory notes which do not bear the signature of a scheduled bank or a co-operative bank for the purpose of regulating credit in the interest of Indian trade, commerce, industry and agriculture.



and drawn for the purpose of holding or trading in securities of the Government of India or a Local Government and maturing within ninety days from the date of such purchase or discount, exclusive of days of grace.

- (3) (a) To purchase from and sell to scheduled banks sterling in amounts of not less than the equivalent of one lakh of rupees;
- (b) to purchase, sell and re-discount bills of exchange (including treasury bills) drawn in or on any place in the United Kingdom and maturing within ninety days from the date of purchase, provided that no such purchase, sale or re-discount shall be made in India except with a scheduled bank; and
- (c) to keep balances with banks in the United Kingdom.
- (4) To give loans and advances to Native States, local bodies, banks and co-operative societies repayable on demand or on the expiry of fixed periods, not exceeding ninety days, against approved securities.
- (5) To make to the Governor-General-in-Council and Local Government advances repayable not later than three months from the date of making the advance.
- (6) To purchase and sell Government securities of the United Kingdom maturing within ten years of such purchase and other securities of the Government of India and Local

Governments, provided that the total amount of such securities held at any time in the Banking Department does not exceed the aggregate amount of share capital of the Bank, the Reserve Fund, and three-fifths of the liabilities of the Banking Department in respect of deposits.

- (7) Custody of monies, securities and other articles of value and the collection of interest and dividend on such securities.
- (8) To sell and realise all property whether movable or immovable which may in any way come into the possession of the Bank in satisfaction of any one of its claims.
- (9) To Act as agent for the Secretary of State, the Governor-General-in-Council or any Local Government or State in India for the purchase, sale and custody of gold and silver, bills of exchange and securities of shares in any company for collection of interest on securities and shares, for the remittance of such proceeds by bills of exchange payable either in India or elsewhere and the management of Public Debt.
- (10) To purchase and sell gold coin and bullion.
- (11) To open an account with or to make an agency agreement with the Central Bank of any other country.
- (12) To borrow money for a period not exceeding one month for the purpose of the business of the bank from a scheduled bank or from the Central Bank of any

other country provided that the total amounts of such borrowings from persons in India shall not, at any time, exceed the amount of the share capital of the Bank.

(13) To make and issue Bank notes.

*Business which the Bank may not transact.*  
The Bank is not allowed to :—

- (i) Engage in trade or to have a direct interest in any commercial or industrial undertaking.
- (ii) Purchase its own shares or the shares of any bank or of any company or grant loans upon the security of any such shares.
- (iii) Advance money on mortgage of immovable property.
- (iv) Make loans or advances.
- (v) Draw or accept bills payable otherwise than on demand.
- (vi) Allow interest on deposits or current accounts.

*Issue of Rupee Coin and Sale and Purchase of Sterling.* The Government shall cease to issue rupee coin except through the Bank. The Bank shall also sell sterling in India for immediate delivery in London at a rate not below  $\text{rs. } 5\frac{19}{64}\text{d}$  for a rupee provided that no person shall be entitled to demand an amount of sterling less than ten thousand pounds. Similarly, the bank shall buy sterling in India for immediate delivery in London at a rate not higher than  $\text{rs. } 6\frac{3}{16}\text{d}$  for a rupee.

*Cash Reserves of Scheduled Banks to be kept with the Bank.* Every scheduled bank shall maintain with the Reserve Bank a balance the amount of which shall not, at the close of business on any day, be less than five per cent of the demand liabilities and two per cent of the time liabilities of such bank in India. For this purpose liabilities shall not include the paid-up capital or the reserves or any credit balance in the profit and loss account of the bank or the amount of any loan taken from the Reserve Bank. If the balance held at the Bank by any scheduled bank is below the prescribed minimum, the defaulter will be liable to pay to the bank in respect of each such day penal interest at a rate of three per cent above the bank rate on the amount by which the balance with the Bank falls short of the prescribed minimum.

*Allocation of Surplus.* After paying out of the net annual profits dividend at a rate not exceeding five per cent, a small proportion of the surplus shall be allocated to the payment of an additional dividend to the shareholders and the balance of the surplus shall be paid to the Governor-General-in-Council.

*Agricultural Credit Department.* The Bank will establish a special Agricultural Credit Department the function of which will be to maintain an expert staff to study all questions of agricultural credit and to co-ordinate the operations of the Bank in connection with agricultural credit with provincial co-operative banks and other banks or organisations engaged in the business of agricultural credit.

*Exemption of the Bank from Income Tax and Super-tax.* The Bank shall not be liable to pay

income tax or super-tax on any of its income, profits or gains but the liability of share-holders in respect of income tax or super-tax shall remain unaffected.

*Publication of the Bank Rates.* The Bank shall make public, from time to time, the standard rate at which it is prepared to buy or re-discount bills of exchange or other commercial paper eligible for purchase under the Act.

The Bank will also publish the accounts of both the Issue and Banking Departments weekly in the Gazette of India.

The Reserve Bank of India Act was passed in March, 1934 and the Bank began to function from 1st April, 1935. From this date the Reserve Bank took over the management of the currency department of the Government of India by the erection of a special department called the Issue Department. The assets of the Gold Standard Reserve were transferred to the Bank and were combined with the assets of the Currency Department. The Bank also took over the duty of supplying the Secretary of State with sterling for his London requirements and of maintaining Government balances which were transferred to it by the Imperial Bank—the Imperial Bank being retained as its agents at places at which the Reserve Bank had no office of its own. From 1st July 1935, the Banking Department was opened and the scheduled banks deposited the required percentage of their demand and time liabilities. The Clearing House was transferred from the Imperial Bank to the Reserve Bank as from this date. In January 1938, the Reserve Bank issued its own notes of the denominations of Rs. 5 and Rs. 10. This was followed later during the year by the issue

of bank notes of the denominations of Rs. 100, Rs. 1,000 and Rs. 10,000. The Bank has also issued Burma bank notes in new designs of denominations similar to those in use in India.

### **Advantages Expected from the Reserve Bank.**

It will be observed that the Act is based on the recognition of the fact that the Reserve Bank should control, but not compete with, the commercial banks. This was particularly desirable in view of the fact that the Reserve Bank has been allowed free use of Government balances and might easily forfeit the confidence and support of other banks by taking undue advantage of this privilege. To ensure control, it has been laid down that all the member banks must keep a fixed percentage of their current and time deposits—5 per cent and 2 per cent respectively—with the Reserve Bank. To prevent competition with the commercial banks, several provisions have been laid down the most important of them being that the Reserve Bank can only take in deposits free of interest, that it cannot grant advances directly to the public, and that it cannot purchase or discount paper unless it bears the signature of a member bank. The Reserve Bank will be able to regulate the amount of seasonal currency through its control over the bank rate and through open-market operations which have been authorised by the Act. The Bank will be able to mobilise the capital resources which are lying about in pools scattered all over the country in the form of hoards. It will also promote habits of banking and investment both directly and by expanding productive activity within the country and thus holding out chances of reaping good profits from new enterprises. The power to deal in foreign exchanges will enable it to reduce exchange fluctuations to the minimum and thus to promote the stability of business and

exchange. By coming into contact with the central banks of other countries it would promote central banking co-operation which is so essential for securing monetary rationalisation and comparative standardisation of world prices. The present economic ills of the world are largely the result of currency and monetary disturbances and the situation can be changed for the better only if the central banks, backed up by the respective governments of their countries, show a spirit of harmonious co-operation.<sup>1</sup> In short, it is hoped that the Reserve Bank, which has started functioning since April 1935, will remove most of the glaring defects of the Indian Money Market and afford much needed relief to trade and industry and more particularly to agriculture which is the largest single industry of our country.

**Rural Finance.** The activities of the principal rural credit agencies viz: the indigenous bankers, the co-operative societies, and the Land Mortgage Banks, have already been discussed. It now remains for us to see how far the Reserve Bank can help the extension of credit facilities in the rural areas. But before doing so we shall point out the distinguishing features of agricultural finance.

**Peculiarities of Rural Finance.** The Indian cultivator, as we all know, is usually steeped in debt. He uses little discretion in the matter of selecting his cattle and implements, and perhaps none in the disposal of his produce. His credit needs are satisfied inadequately and at ruinous prices. But agriculture should be a productive, and a profitable industry; why should the cultivator

1 That this spirit is for the moment lacking is proved by the failure of the World Economic Conference which had raised high expectations in the minds of people all over the world.

find it difficult to raise necessary credit when traders and manufacturers are able to do so without any difficulty ? The answer is simple enough. In the first place, the agriculturist borrows money on the security of one man, or at the most one family, and the method of raising capital by subscription of shares employed by the joint-stock companies is not open to him. Secondly, the long-term loans are usually raised against the security of land, but land is a most unsuitable form of security because it is not a readily realisable asset and its price is liable to frequent changes. There may also be difficulties in connection with title and customary or statutory restrictions on the right of transfer. Thirdly, while other industries tend to become concentrated in units of ever-expanding size, agriculture remains scattered, individualistic, small scale and chaotic. Hence, the farmer remains dependent upon his own resources and the savings of the community in general are relatively inaccessible to him. Fourthly, agriculture is a very uncertain industry. The capital of the farmer is, for the greater part of the year, sunk in the forms of wealth which none but an expert can value on the basis of the probability of a successful yield of crops and which, therefore, cannot be regarded as good security for an advance. His own illiteracy and ignorance reduce his credit-worthiness to the very minimum. Fifthly, the agriculturist cannot easily adjust the supply of his produce to demand. He cannot abandon his land even when the demand for produce goes down. Hence loans taken at a time when prices are uneconomic often hang like a millstone round his neck especially if the cultivator is also ignorant of the two cardinal points of farming viz: what farming costs and what it brings him.

The problem of establishing a satisfactory link



between the agricultural industry and the money market *i. e.* between the farmer seeking credit and the capital seeking investment has not been satisfactorily solved in any country of the world. The ordinary commercial banks can only afford to lend money for short periods and expect the loans to be repaid punctually when they fall due. The agriculturist, however, cannot satisfy these conditions. His repaying capacity is limited by the uncertainties of the season and in the event of famines and floods the redemption of the loan must be postponed until the return of better conditions and must eventually be made in small instalments spread over a number of years. "The rapid circulation of money being essential to the success of a commercial bank and the bulk of its working capital being derived from short-term deposits or call money, a commercial bank cannot, generally speaking, afford to postpone its recoveries or tie up its resources to accommodate the farmer's needs." It is, therefore, clear that, in the present state of our agriculture, there cannot be any direct contact between the commercial banks and the cultivators. Some intermediaries like the money-lenders or the co-operative societies are quite unavoidable and their resources can be mobilised and their activities properly co-ordinated in the interest of rural finance only through contacts which may be established between them and the central bank of the country.

**Reserve Bank and Agriculture.** Accordingly, the Reserve Bank Act has imposed certain obligations upon the Reserve Bank according to which it can place its resources at the disposal of the agriculturist without violating the essential principles of central banking. For instance, while bills and promissory notes against which the funds of the Reserve Bank may be obtained must relate to

short-term needs *i. e.* the financing of seasonal agricultural operations or the marketing of crops only, the maturity of such bills and notes is extended as a special case to a maximum of nine months. Moreover, while the principle that the funds of the Reserve Bank can be available only for the relief of exceptional pressure on the resources of intermediary banks is strictly adhered to, the endorsement of the provincial co-operative banks is given as a special case the same status as the endorsement of a scheduled bank for the purpose of purchase, sale or re-discount of these bills. As for loans and advances, the provincial cooperative banks can obtain them from the Reserve Bank but on the same conditions as scheduled banks *i. e.* for a minimum period of 90 days and against government securities, agricultural paper and document of title to goods.

**Agricultural Credit Department.** The Reserve Bank has also set up a separate Agricultural Credit Department the functions of which are (a) to maintain an expert staff to study all questions of agricultural credit and be available for consultation to all banks and banking organisations, and (b) to co-ordinate the operations of the Bank in connection with agricultural credit and its relations with provincial co-operative banks and any other bank or organisation engaged in the business of agricultural credit.

The Bank was also required to make a report to the Governor-General-in-Council, at the earliest possible time and in any case within three years of the establishment of the Reserve Bank, on two specific points viz: (a) the extension of Reserve Bank facilities to persons and firms who did not fall in the category of scheduled banks (money lenders and co-operative societies); and (b) the improvement of machinery for dealing with agricultural finance and methods for effecting a closer

connection between agricultural enterprise and the operations of the Bank.

The report was issued in due course and has been supplemented by several bulletins containing the views of the Reserve Bank on the whole question of agricultural credit and indigenous banking. It points out the difficulties we have already noted about the inclusion of money-lenders and indigenous bankers within the organised banking structure of the country, particularly their unwillingness to shed non-banking business and adoption of modern accounting and banking practices. In regard to the co-operative movement, it has made out a strong case for re-construction of the whole structure. "While overdues are scaled down and passed on to long-term credit institutions and co-operative credit societies restrict themselves in future to crop loans repayable out of the harvest or intermediate credit in a limited measure, an endeavour should be made to enlarge the functions of these societies so that they cover the whole life of the farmer *i. e.* become multiple-purpose societies. The financing agency is to consist of two stages : banking unions for small areas with a radius of 7 to 8 miles, and provincial co-operative banks. Strict observance of business and banking principles, highly trained staff etc., are other directions in which improvement is urgently necessary."<sup>1</sup>

In a circular dated June 12, 1939, the Reserve Bank has refused to recognise any difference between commercial banks and co-operative banks from the banking point of view except that the former cater for the needs of the trade and industry while the latter primarily finance agriculture and has emphasised that the same conditions of safety and liquidity in the employment of funds are essential for the

1 Muranjan, *Modern Banking in India*, pp. 282-3.

stability of both. The Bank has further stressed the necessity of stating overdues clearly and separately in the balance sheets, separating long-period from short-period loans to the maximum of an amount equal to the paid-up capital and reserves, doing away with the practice of fictitious repayments which conceal the real position not only from outsiders but also from those who are in authority over the bank and building up strong reserve funds.

**Reserve Bank in Action.** The reserve Bank started functioning under very favourable circumstances. The bank rate which stood at 6 to 7 per cent for more than nine months in 1931 had fallen to  $3\frac{1}{2}$  per cent in April 1935. The Bank reduced it to 3 per cent in November 1935 and has maintained it upto the present day. It has thus reduced and stabilised the rate for money and has offered cheap and valuable inland remittance facilities.<sup>1</sup> It has attained a remarkable measure of success in the management of the Public Debt and especially in the floatation of loans for the Central and Provincial governments, in the making of remittances to

1 The Reserve Bank introduced a new scheme of remittance facilities in October, 1940 the object of which is to extend the remittance facilities to non-scheduled banks and to make them cheaper. According to the scheme, whereas the rates to be charged to the public are  $\frac{1}{2}$  per cent for remittances upto Rs. 5,000 and  $\frac{1}{16}$  per cent for remittances above that amount, the corresponding rates for approved indigenous bankers, non-scheduled banks, and co-operative societies are  $\frac{1}{16}$  per cent and  $\frac{1}{32}$  per cent. Indigenous bankers and non-scheduled banks, however, must satisfy certain conditions viz: that they must have a minimum owned capital of Rs. 50,000 and that banking must form their main business. They must also conform to the money lending regulations of their respective provinces

the Secretary of State, in the sale of the Treasury bills and in stabilising the exchange value of the rupee. It has also given valuable advice regarding the incorporation of new provisions relating to banking companies in the Indian Companies Act. In short, the working of the Bank during the last seven years has justified the claim that "it has inaugurated a new era of financial stability, banking reform, and extension and re-orientation of the money market."<sup>1</sup>

But, as has been pointed out before, the Bank has so far failed to assimilate the indigenous money lenders in the banking system of the country and has not yet succeeded in developing a regular bill market. It has also lost a good deal of public confidence on account of the questionable treatment meted out to the Travancore National and Quillon Bank. This scheduled bank was in serious difficulty in June 1938 and applied for financial accommodation which was refused unless the bank subjected its accounts to thorough examination by the Reserve Bank. Such a scrutiny, the scheduled banks contend, should be made *before* and *not just when* a serious emergency arises. Moreover, since the T. N. Q. Bank had withdrawn a part of its compulsory deposits with the Reserve Bank, the latter's offer of help was limited to the funds still in its possession. This is also wrong in principle. "Central Bank aid should have no relevance to the volume of compulsory reserve lodged with it but only the general position of the bank and the volume of its realisable assets. If aid were to be limited to the volume of compulsory reserves, scheduled banks might as well keep their balances with themselves and forego the dubious advantage of affiliation."<sup>2</sup>

1 Jathar and Beri, *Indian Economics*, Vol. II, p. 502.

2 Muranjan, *Modern Banking in India*, p. 287.

The administration of the Reserve Bank also needs improvement. Due to the lack of real expert *personnel* at the top, the Reserve Bank has proved to be nothing more than a costly continuation of the old system of departmental control of currency. In Great Britain it has been increasingly realised, especially in the last ten years, that both the Treasury and the Bank of England have to be considerably strengthened with men deeply versed in Economics and public finance. The additional *personnel* taken on both the Treasury and the Bank of England in recent years, therefore, comprise a large number of some well-known economists. The Reserve Bank of India has, in a scheme of controlled money, been obliged to take up multifarious duties the successful discharge of which can be accomplished only by constant additions, not of mere routine men, but of specialists who can claim to have practical experience and appropriate theoretical knowledge. It is, therefore, suggested that when the tenures of the Governor and the Deputy Governor expire the Government should try to secure the services of people well-versed in the art and science of banking and public finance especially from among the young eligibles of this country.

Another interesting point revealed in the report of the Central Board of Directors is that the number of shareholders in the Bombay area has increased at the expense of other areas, principally Calcutta and Rangoon. According to the Reserve Bank Act, each share-holder has one vote for each five shares subject to a maximum of ten votes so that if this tendency continues, blocks of shares might become concentrated in the hands of a few holders with the effect of restricting the electorate and the risk of detracting from the representative character of the directorate chosen by it. The Directors have reported the position to the Government with the

suggestion that they might consider the limitation of the shares that a holder may register in his name to a maximum of 200 shares but the Government has not yet taken any action upon this recommendation.

Sir James Taylor has also drawn the attention of the Government to another important point, namely, that the deposit of 5 per cent of their demand liabilities and 2 per cent of their time liabilities which the Scheduled Banks are obliged to keep with the Reserve Bank is not quite satisfactory. These deposits work out probably on the average at about  $3\frac{1}{2}$  per cent of a bank's funds and there is nothing to prevent the banks from investing the rest of their funds in any way they like. Moreover, the banks are permitted to withdraw a part of the compulsory deposit provided they pay a heavy rate of interest by way of penalty. The very fact that the bank draws on its statutory deposit would of itself indicate that the bank had no security against which it could borrow money from the Reserve Bank and that most of its funds are locked up in frozen assets. Hence, in the interest of sound banking in general and to protect the depositors in particular, the Reserve Bank has recently<sup>1</sup> been empowered to prohibit, if necessary, a defaulting bank from receiving fresh deposits during the period of default and to penalise directors and other officers who may have been knowingly and willfully party to a default. But to prevent bank failures and to save the Reserve Bank from embarrassing situations like the one that cropped up in connection with the T. N. and Q. Bank, the need for some sort of closer control over scheduled banks is evident. Three measures of control have been suggested.<sup>2</sup> "The first is that no new banks should be incorporated without the

1 November, 1940.

2 By the Editor of the *Journal of the Indian Institute of Bankers*, in the July (1940) issue of the Journal, pp. 10-12.

assent of the Reserve Bank of India and the agreement of the Government of the Province in which the bank is to function. The second would be the appointment of Bank Examiners under the control of the Reserve Bank to perform periodical examinations. Such examinations must not be perfunctory or set to a fixed time schedule. They would be made in particular without delay in the case of any bank whose returns indicated loose or unsound working but they would have to be made with due circumspection. The third form of control would be the provision that a bank should carry a proportion of its liabilities in India in cash, call-money with the Reserve Bank or other approved depositors, and in securities approved by the Reserve Bank, i.e. securities against which the Reserve Bank would be prepared to advance. In this respect a monthly return from all banks could be made obligatory, such return summarising principal assets and liabilities."

**Effects of the Present War on Banking in India.**  
**Deposits of Scheduled Banks.** The effects of the War on the deposits of the Scheduled Banks have already been traced.<sup>1</sup> It has been pointed out that although in the beginning the deposits tended to decline, public confidence did not take long to return and the deposits reached the high level of Rs. 261 crores in April, 1940. It will also be noticed that the time deposits, during this period, increased more than the demand deposits due perhaps to the willingness of banks to accept time deposits in order to finance the increased war activity which coincided with the seasonal trade activity.

With the intensification of hostilities in May, however, there set in a declining tendency and

1 Chapter XIII. pp. 192-194.



the total deposits fell sharply from Rs. 261 crores at the beginning of May to Rs. 252½ crores at the end of June, a fall of Rs. 11½ crores. The panic, however, was soon allayed and the total deposits rose to about Rs. 292 crores in May, 1941.

The figures on page 193 will also show that the time and demand deposits, after June 1940, have moved in opposite directions for while the former declined from about Rs. 107 crores in July 1940 to Rs. 101 crores in January 1941, the latter increased from Rs. 150 crores to about Rs. 178 crores during the same period. This was due partly to the desire on the part of the public to keep their funds liquid but mostly to the cautious attitude adopted by banks in financing the seasonal movements of crops owing to the fear that the accumulation of these crops at the ports resulting from the closing of a number of European markets and the difficulties with regard to freight might depress prices.<sup>1</sup>

**Advances and Bills Discounted.** During the first seven months of the war when the total deposits of banks increased only by about Rs. 7 crores, the advances by banks, including bills discounted, increased by Rs. 46.67 crores and reached the figure of Rs. 163 crores which is the highest recorded since the inception of the Reserve Bank. This was obviously due to the sudden improvement of trade and rising prices. But towards the end of March there was a sharp fall of prices and the banks did not lend as freely as before with the result that advances fell from Rs. 156 crores on March 29 to Rs. 99.59 crores on December 20 or by Rs. 56.87 crores and the discounts decreased from Rs. 6.64 crores to Rs. 2.21

<sup>1</sup> See Mr. B. L. Panjabi's excellent *Notes on Banking in India in 1940* in the *Journal of the Indian Institute of Bankers*.

crores *i.e.* by Rs. 4.43 crores during the same period. As was to be expected, the percentage of banks' advances and discounts to their deposits, which reached the peak in March 1940, declined from 62.5 to 39 by the end of the last year but again rose to 53 in May 1941 as the following figures will show:—

## ADVANCES AND DISCOUNTS OF SCHEDULED BANKS

Date.	Advances (in lakhs of rupees)		Bills Discounted (in lakhs of rupees)	
	Amount.	Increase or decrease	Amount.	Increase or decrease.
August, 25, 1939	105,27	...	3,99	...
September, 29, "	112,44	+ 7,17	3,12	- 67
October, 27, "	111,20	- 1,24	2,45	- 67
November, 24, "	119,47	+ 8,27	3,26	+ 81
December, 29, "	143,16	+23,69	4,68	+1,42
January, 26, 1940	150,17	+ 7,01	4,86	+ 18
February, 23, "	149,25	+ 92	5,84	+ 98
March, 29, "	156,46	+ 7,21	6,64	+ 80
April, 29, "	151,73	+ 4,73	6,80	+ 16
May, 31, "	153,68	+ 1,95	6,97	- 23
June, 7, "	148,41	- 5,27	6,03	- 54
July, 19, "	132,11	- 16,30	3,55	- 2,48
August, 16, "	123,28	- 8,83	2,24	- 1,31
September, 13, "	115,84	- 7,44	1,71	- 53
October, 18, "	105,71	- 10,13	1,60	- 11
November, 15, "	99,32	- 6,39	1,94	+ 34
December, 20, "	99,59	+ 27	2,21	+ 27
January, 10, 1941	103,99	+ 4,40	2,80	+ 59
February, 14, "	112,21	+ 8,22	4,61	+1,81
March, 14, "	118,56	+ 6,35	5,99	+1,38
April, 18, "	130,92	+12,36	6,81	+ 82
May, 16, "	131,74	+ 82	6,56	- 25
		+26,47		+2,57

**Cash Position of Banks.** Due to a steady rise in deposits and a rapid fall in advances, the cash position of banks became particularly strong. The ratio of banks' cash (including balances with the Reserve Bank) increased from 8·9 per cent at the end of March to 50·5 per cent at the end of December, 1940. In these circumstances it was but natural that easy money conditions should prevail in the money market since April, 1940.

**Bankers' Balances with the Reserve Bank.** The balances held by scheduled banks with the Reserve Bank of India amounted to Rs. 22 crores at the end of April but by June they had fallen to Rs. 19·63 crores. Thereafter, they showed an almost continuous rise and reached the figure of Rs. 51·86 crores in November, 1940 which was about Rs. 40 crores in excess of the statutory minimum required by the Reserve Bank Act. A part of the increase, no doubt, indicated the anxiety of the banks to keep their resources liquid to meet possible withdrawals but the greater part of it reflected the seasonal demand for money. It will also appear from the table below that the balance of scheduled banks with the Reserve Bank have fallen from about Rs. 52 crores in November, 1940 to about Rs. 26 crores in May, 1941. This is due to the increase of advances which have taken place during the same period.

## BALANCES OF SCHEDULED BANKS WITH THE RESERVE BANK

[In lakhs of rupees]

Date		Amount	Increase or decrease	Date	Amount	Increase or decrease
August, 25,	1939	26,61	- 11,59	July, 19,	29,48	+ 9,85
September, 29,	"	15,02	+ 4,44	August, 16,	36,11	+ 6,63
October, 27,	"	19,44	+ 40	September, 13,	42,74	+ 6,63
November, 24,	"	19,84	- 2,82	October, 18,	48,91	+ 6,17
December, 29,	"	17,02	+ 1,88	November, 15,	51,86	+ 2,95
January, 26,	1940	18,90	- 2,10	December, 20,	49,02	- 2,84
February, 23,	"	16,80	+ 37	January, 10,	44,63	- 4,39
March, 29,	"	17,17	+ 5,14	February, 14,	43,94	- 69
April, 26,	"	22,31	- 6,89	March, 14,	38,65	- 5,29
May, 31,	"	15,42	+ 4,21	April, 18,	26,42	- 12,23
June, 7,	"	19,63		May, 16,	26,08	- 34
						- 44

BANKING AND THE INDIAN MONEY MARKET

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**Non-scheduled Banks.** Like the scheduled banks, the non-scheduled banks have also stood the strain of the War very well. Their deposits have remained fairly steady except perhaps during the first four months when the rush for withdrawals was intense.

**Conclusion.** From what has been said above it is quite clear that the Indian banking situation, like the currency position, is quite sound. Our bigger institutions are so scientifically and skilfully run that it has not been found necessary for any one of them, except perhaps on one occasion, to have recourse to the Reserve Bank for advances against Government securities or for discounting of commercial bills. The same, however, cannot be said about the smaller banks. Some of them are good, some bad, some indifferent. It would be necessary, at some stage, to weed out the weaker ones by amalgamation or some such movement. Meanwhile, it would be most inopportune if any of them should find themselves obliged to suspend payment. Whatever one's views be about the desirability or otherwise of the aggregation of these smaller institutions, there must be general agreement on two main points, namely; (1) that, like the poor, these banks have been with us for years and they are part of the banking organization and we cannot be blind to their existence, and (2) that they should not be allowed to come to grief at this juncture. The process of weeding out the inefficiently organized smaller banking institutions should await the conclusion of the War. At present they should, if necessary, be bolstered up and assisted to bear the strain of abnormal economic conditions.

**Industrial Finance.** While a good deal is being

done to help the agricultural development of the country, the need for rapid industrialisation does not seem to have been sufficiently realised. It is a well-known fact that India has an enormous potential wealth possessing as she does a variety of raw materials, but instead of utilising them for the development of her industries she has been merely content to export them to be converted into intermediate products and finished goods in other countries. She is, therefore, wholly dependent on foreign countries for the supply of intermediate products like the plant and machinery and chemicals which she requires and the production of which may be regarded as the index of the industrial progress of any country. "The need for rapid industrialisation can hardly be exaggerated from a purely economic point of view as it will tend to absorb that portion of the population which cannot be supported by agriculture, will provide a remedy for the gradually increasing unemployment among the middle-class people, and will result in an improvement in the standard of living generally."<sup>1</sup> The problem has become particularly important because of the War which is now on. New industries have been started (*e. g.* chemical, radio-manufacturing etc.) and others are under contemplation (*e. g.* aircraft and motor car manufacture, ship-building<sup>2</sup> etc.) but until suitable provision for financing these and other prospective industries is made no ocular results of any value should be expected. The following pages will, therefore, be devoted to the examination of the needs of different industries with suggestions for providing adequate financial assistance.

**The Requirements of Industries.** Broadly speaking, an organised industry requires two

1 *Central Banking Enquiry Committee Report*, p. 262.

2 A beginning has already been made by the Scindia Steam Navigation Company.

kinds of finance: fixed or block capital and floating capital or short-term accommodation for its day to day needs. The former includes not only the initial loans which are required for purchasing land, erecting factory buildings and installing plant and machinery, but also the more or less permanent funds which an old established concern needs to extend and re-organise itself. The floating or working capital is required for the purchase of raw materials and stores, for expenses incidental to the marketing of products and for providing the necessary funds for paying wages and meeting the day-to-day requirements

The relative proportion between block and working capital required by an industry naturally depends upon the nature of the industry itself. The more round-about and complex the process of production, the greater must be the proportion of fixed to working capital. For instance, in the case of hydro-electric, iron and steel, jute and cotton industries, block capital is very large in relation to working capital. On the other hand, in the case of cottage industries which require less expensive tools and implements, working capital plays a more important part.<sup>1</sup>

In between the above two kinds of credit, long and short-term, industries frequently require credits for intermediate periods *i. e.* for periods varying from one to five years. Provision has, therefore, to be made for all the three kinds of financial facilities *viz:* short, medium and long-term although, as we shall see presently, the third form is by far the most important.

1 The amount of working capital needed in an industry depends mainly upon the value of the output and the average length of time occupied by the productive process. But there are other governing circumstances as well. The time at which a manufacturer gets paid and the methods of buying raw materials and effecting sales often affect the amount of working capital needed by a particular industry. See P. S. Lokanathan, *Industrial Organisation in India*, pp. 157-158.

**Existing Facilities—Major Industries.** The working capital of major industries is usually derived from four sources *viz* : (1) public deposits ; (2) private deposits including the sums of money advanced by the entrepreneurs, their friends and the managing agents ; (3) indigenous money-lenders ; and (4) the joint-stock banks. Let us briefly consider the part played by each of these in the financing of industrial enterprise in India.

The system of public deposits prevails largely in the cotton textile industry of Bombay and Ahmedabad. The mill-owners of these places are often able to attract large sums of money by way of deposits from the people of their own community, especially from those seeking safe yet profitable investment for their small savings. This system of industrial finance proves quite successful in normal times but it has certain inherent weaknesses. For instance, in times of stringency, mills whose financial position is not strong find real difficulty in obtaining deposits. Infact the tendency of depositors to withdraw their money on the slightest rumour of difficult times ahead puts the mills in a most awkward position.<sup>1</sup>

The private deposits of entrepreneurs and their friends have also played an important part in financing the medium-sized and comparatively new industries in India like the tea-gardens of Bengal and Assam and some of the sugar and match factories. But by far the most important source of industrial finance is the managing agents. All the more important jute mills, cotton mills, tea gardens and the greater part of sugar factories, electric supply companies and light railways were established and are still managed by them.

A managing agent combines in himself the functions of the entrepreneur, the capitalist and the

1 Also read N. Das, *Industrial Enterprise in India*, pp. 8-10.



businessmanager and it would not be an exaggeration to say that "A number of prosperous and flourishing industries of today would have yet been in the womb of future without the initiative of managing agents."<sup>1</sup> Nevertheless, the system of financing by managing agents has been open to grave defects. For example, it is an open secret that the surplus funds of one mill are often invested in the shares and debentures of other mills and that the funds raised on the credit of one concern are occasionally lent to another under the same managing agents. The number of companies under the control of a managing agent is usually so large that it becomes impossible to finance *any one* adequately. Trading and speculation by managing agents is another great defect because the banks are known to have withdrawn their cash credits from agents who lost in speculation although the mills themselves were intrinsically sound. Some of the methods adopted by the managing agents in financing industry are also questionable. For example, in many cases they have turned their loans into debentures with the result that the concerns have passed into their hands and the share-holders have lost all their capital invested in them. The managing agents of the present age, moreover, unlike their predecessors, have no knowledge of manufacture—engineering, technical or scientific. They are not experts in buying and selling and "the various irregularities committed in filing balance-sheets, lists of share-holders, extra-ordinary resolutions with the Registrars of Joint Stock Companies are an illuminating commentary on their knowledge of commercial law and training in secretarial work."<sup>2</sup> Under the circumstances, the financing of industries should be made less dependent on the managing agency system than hitherto.

1 S. K. Basu, *Industrial Finance in India*, p. 165.

2 Basu, *op cit*, page 190.

The importance of the indigenous bankers in the realm of industrial finance is gradually diminishing. They are now mostly patronised by the small industrialist who does not wish to "expose himself to the enquiries, the regularised procedure and the greater risks of a joint stock bank with a grilled counter and the uniformed peon in the doorway"<sup>1</sup> and is, in consequence, willing to pay higher rates of interest. Coal companies, for instance, have to borrow money from the indigenous bankers for the practical development of their collieries at as high a rate as 12 to 18 per cent and sometimes even at 24 per cent. Industries like leather tanning, oil mills, rice mills, smaller tea-gardens etc., have to pay as high as 24 per cent even when they borrow on the security of their assets.

The ordinary commercial banks employ their short-term deposits for providing working capital to the principal industries of the country *viz*: jute, cotton, iron and steel etc. The advances given by these banks fall under two main heads: (1) advances against tangible and marketable security lodged or pledged with the lender; and (2) clean advances against personal credit with a second signature to the promote. In India there are very few clean advances without a second signature—a class of advances that occupy an important place in the highly developed banking systems of Europe and America.<sup>2</sup>

1 N. Das, *Industrial Enterprise in India*, p. 14.

2 *Central Banking Enquiry Committee Report*, p. 380.

It should also be remembered that the most useful form of borrowing in India is the *cash credit* account under which an advance is allowed against a promissory note signed by the borrower and secured by the hypothecation of stocks. Under this system, interest is paid by the borrower only to the extent to which the credit is availed of from day to day and he can reduce his obligation at any time subject, in some cases, to a minimum interest clause *i.e.* subject to the provision that the bank would charge its clients interest on a minimum amount which is generally one-half of the maximum limit of the drawing power allowed to the borrower by the bank. Similarly, the lending bank can curtail and withdraw the facilities at any time. The system is thus advantageous to both sides.

The attention of the Central Banking Enquiry Committee was drawn to the fact that in making loans banks are generally willing to take account only of tangible and easily realisable assets like stocks etc., but not of block capital. It was also pointed out that margins as large as 30 per cent and more were claimed and enforced against tangible and realisable assets and that the rates charged were more than the industry could bear. But all said and done it may be assumed that the demand for short-term industrial credit is satisfied fairly cheaply and adequately. The same, however, cannot be said about long-term capital. The Indian investing public is proverbially shy and often reluctant to make direct investment in industries<sup>1</sup> and the insurance companies invariably prefer government or semi-government securities to industrial paper. The Imperial Bank even now cannot make any loan or advance for a period exceeding nine months and is not permitted to lend upon mortgage or infact against any immovable property except in the case of estates under the charge of court of wards. The other Indian joint stock banks are essentially commercial banks and cannot afford to lock up their short term liabilities in long term investments. The share of the Exchange Banks in industrial financing is practically nil. They were founded and are controlled by foreigners and they cannot possibly have any interest in the indigenous industries. Even otherwise the nature of their business precludes long-term industrial financing. Hence,

1	Joint-Stock Companies			
	(in Calcutta List)		(in Bombay List)	
Share Capital	...	Rs. 76.37 crores.	Rs. 52.83 crores.	
Debentures	...	„ 8.65 „	„ 17.51 „	„

Indian Central Banking Enquiry Committee, Vol. I, Part II (Minority Report) page 335.

the industries often raise long-term loans either by issuing preference or debenture shares none of which is unfortunately very popular in this country.

The difficulties pointed out above have often been emphasised to make out a case for separate industrial banks as distinguished from the ordinary commercial banks, *i. e.* for creating separate institutions dealing with long and short-term credit respectively. There is, however, hardly an example in economic history where such a separation of banks has existed and has expedited industrial and economic progress. On the contrary, examples of countries which adopted mixed banking and hastened their industrialisation are more numerous. In Germany, for example, the ordinary banks play a very important part in satisfying the financial requirements of industries. They provide the greater part of the initial capital which is subsequently placed among the investing public. In order to distribute the risk it is a very common plan for several banks to join together in a *Konsortium* and pledge themselves to accept a certain portion of the issue. It must, however, be emphasised that the banks invest only a limited portion of their resources in industrial finance and that ordinary banking business constitutes their major activity. The Central Banking Enquiry Committee also suggested the establishment of direct friendly relations between industrial companies and commercial banks.<sup>1</sup> But they overlooked the fact that not one of the joint stock banks of India, with the possible exception of the Imperial Bank, is fitted today to embark on the undoubtedly difficult and complex policy of "mixed" banking. The reasons are obvious. Firstly, most of these

1 For a very able discussion of this point see Muranjan—*Modern Banking in India*, pp. 156-161

banks have meagre resources in paid-up capital and reserves and they cannot afford to lock up short period deposits in long term advances. Secondly, there is still a very low level of understanding and integrity among many of the bankers today and, until things improve, it would be dangerous for them to embark on "mixed" banking operations. Thirdly, the whole history of industrial finance in India shows that investment banking by institutions which are organised as commercial banks inevitably leads to speculation and rash promotion.<sup>1</sup>

**Industrial Banks.** Hence, while we support the policy of establishing better contacts between the commercial banks and industrial concerns, we do not under-estimate the importance of purely industrial banks. Such banks have been tried by Germany and Japan with conspicuous success. The German Banks attend on industrial undertakings from their birth to their death; from promotion to liquidation." These banks, called *Gross-bankens*, actively participate in industrial ventures by taking up and underwriting and eventually selling blocks in these ventures. They exercise a great measure of control over the industries through their representatives and directors. They have a highly paid staff to evaluate the assets and the possibilities of failure of fresh industrial schemes. In Japan also the growth of industries has been fostered by the Industrial Bank of Japan which was established in 1902. Even England, the home of *Laissez Faire*, has realised the wisdom of establishing such institutions as the Securities Management Trust and the Bankers' Industrial Department Company. The first industrial bank of India was the Tata Industrial

1 N. Das, *Industrial Enterprise in India*, pp. 42-43.

Bank. It started work in 1918 but had unfortunately to suspend the industrial side of its activities in 1922.<sup>1</sup> The Industrial Commission had also urged the necessity of establishing such institutions in 1919.<sup>2</sup> The Central Banking Enquiry Committee recommended the establishment of Provincial Industrial Corporations to provide better financial facilities to industries within their jurisdiction and an All-India Industrial Corporation to finance industries of great national importance, particularly those which cannot be supported out of provincial resources. An All-India Bank is expected to command not only ready finance but large capital with necessary safety to investors as it would be able to engage financial experts.

Whether such banks should be started privately or with the help of the State is a debatable point. Those in favour of State-aid harp upon the shyness of Indian capital and suggest that only an industrial bank aided by the State can mobilize capital and turn it into productive channels. They also point out that an institution aided by the Government would inspire the confidence of all investors who would, therefore, take more interest in industrial issues and debentures and this change of outlook on their part would eventually be to the advantage even of those undertakings that have not come to the bank for financial help.

Those against State interference, on the other hand, maintain that State-aid through a bank is not likely to solve all the difficulties with which the

1 For the present position of Industrial Banks of India read Muzanjan, *Modern Banking in India*, pp. 163-165.

2 The Industrial Commission had suggested that the Industrial Banks should possess the following features :—

- (1) High paid-up share or debenture capital.
- (2) Distribution of the loans over a good number of industries instead of staking everything on the success of a few.
- (3) Careful scrutiny and limitation of loans.

industries in India are faced now-a-days. Infact they believe that a state aided Bank would lead to political pressure of various kinds and would probably lead to the suppression of industries which are likely to compete with vital industries of foreign countries. Considering, however, that an Industrial Bank requires a large amount of capital and expert *personnel* for assessing the soundness or otherwise of the various industrial undertakings some sort of Government assistance seems to be quite desirable. Therefore, the ideal bank, for the moment, should be started with private capital and enterprise and the Government should insure the promoters and share-holders against losses.

**Industrial Banks and Small Industries.** The small-scale industries present difficulties of their own. For instance, their shares and stocks, if ever they exist, have hardly any market value. Controlled by relatively obscure management and existing in scattered and obscure places, the technique of financial aid and supervision have to be on a different scale and altogether different in character. Their problems of marketing are more difficult and urgent than those of production. Therefore, although the advantages of specialised industrial banks for large industries may be doubtful, they certainly can perform valuable services to small-scale or cottage industries.

**Indian Companies Act of 1913 as amended in 1936.** Some important amendments to the Indian Companies Act of 1913 which came into effect on January 15th 1937 have established a certain amount of banking control as contemplated by the Banking Enquiry Committee in 1929. The most important aspects of this recent legislation may be summarised as follows.—

#### I. *Segregation of banking from commercial*

*operations.* A banking company is defined as a company which carries on, as its principal business, the accepting of deposits of money on current account or otherwise subject to withdrawal by cheque, draft or order. Banking Companies found after January 15th, 1937, must conform the objects of transactions to those enumerated in the amended Companies Act (Section 277 F).

2. *Cash Reserves.* Banking companies are required to keep as cash reserves  $1\frac{1}{2}$  per cent of their time liabilities and 5 per cent of their demand liabilities and to file, every month, with the Registrar a statement of the amount so held.

3. *Reserve Fund.* Banking companies are required to build up a reserve fund by allocating to it 20 per cent of the annual net profits until the fund is equal to the paid-up capital.

4. *Special Status of Scheduled Banks.* The special status of the scheduled banks has been recognised and statutory controls as, for instance, in the matter of building up reserves which have been applied to non-scheduled banks, have not been extended to scheduled banks on the ground that the latter can be left to the general supervision and control of the Reserve Bank.

It will be observed that these provisions deal only perfunctorily with banking business and do not touch more important issues like licensing of banks and restricting the activities of foreign exchange banks etc., suggested by the Banking Committee.

**Banking Legislation.** The working of the Reserve Bank Act and the Indian Companies Act in the last three years demonstrated the need of



comprehensive legislation to control banking business and to promote its orderly development in this country. Sir James Taylor, therefore, submitted a scheme for the consideration of the Government of India the main provisions of which are:—

(1) The proposed legislation is to apply to all those institutions which accept deposits withdrawable by cheques.

(2) Every company engaged in such business shall have to include as part of the name of its business any of such words as “bank”, “banker”, or “banking”. No such company shall employ individuals as managing agents or be managed by a company other than a banking company.

(3) For each branch which a bank opens in any of the three Presidency centres, namely, Madras, Bombay and Calcutta, the bank shall have a paid-up capital of Rs. 5 lakhs for each such centre. And for every branch that a bank opens in a centre where there are already two branches of other banks, the bank in question must have a paid-up capital of Rs. 50,000. The minimum paid-up capital of any bank is fixed at Rs. 50,000.

(4) Every bank should hold 30 per cent of its current time liabilities in the form of Government Securities.

(5) Liquidation must be made more promptly and liquidation proceedings simpler and speedier.

(6) Cooperative Banks will be excluded from the operation of the proposed legislation.

The scheme aims at a simpler and more restricted definition of banking and banking companies than is contained in the Indian Companies

Act (Section 277 F) and more particularly at remedying the existing anomaly under section 277 G of that Act under which institutions incorporated prior to January 15, 1937 may continue to call themselves banks and yet refuse to comply with the statutory provisions relating to banking companies. It also seeks to ensure that an institution calling itself a bank has sufficient capital and that banks with inadequate resources will not open branches in the large towns where branches of other banks already exist. It also contemplates certain moderate restrictions on bank investments in order to protect the depositors and attempts to provide for simple and quick liquidation proceedings so that in the event of a bank failure the depositors may be paid off with the minimum of delay and expense of litigation.

The proposed measure will undoubtedly go a long way in safeguarding the interest of the depositors and generally in putting banking on a surer footing.

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#### SUMMARY

**Members of the Indian Money Market.** The Money Market in India consists of the Indigenous Bankers, the Joint Stock Banks, the Foreign Exchange Banks, and the Imperial Bank on one side and the Reserve Bank on the other. Reference has been made to Post Office Savings Banks, Co-operative Banks and Land Mortgage Banks.

✓ **The Indigenous Bankers.** They have existed in India from times immemorial under a variety of names and have rendered very useful service to the country. Their business, which is handed down from father to son, consists in giving loans against different forms of securities. They seldom accept deposits but readily invest their money in discounting *hundis* and in speculation. They are frequently denounced for charging very high rates of interest and for keeping mysterious accounts.

Most of this criticism will lose weight if it is remembered that the money-lenders deal with illiterate people who are always anxious to forget and repudiate their liability. In addition to the risk of life and property, the growing apathy of law courts may also be held responsible for the desire on the part of the *sahukars* to protect themselves by charging high rates of interest. Moreover, the flexible terms offered by them and their pleasant manners, alertness and personal interest are invaluable assets which are lacking in other banking institutions. They can certainly be made more useful by adopting up-to-date methods of banking like keeping proper accounts, use of cheques etc., and by being combined into a sort of a co-operative bank.

The Reserve Bank has recently propounded a scheme by which the central banking facilities can be extended to the indigenous banks also provided they satisfy certain conditions. But the scheme has not been well received. The indigenous bankers are neither willing to abandon their age-old business nor to make financial position known to the public although they are prepared to supply necessary information to the Reserve Bank when required.

✓ **Joint Stock Banks.** They are registered under the Indian Companies Act. First started with the help of foreign capital, they have had a chequered career. Many banks failed before the war owing to the inefficiency of management and indifference of the Government and the episode was repeated first in 1923 and then in 1932. A majority of them are now controlled by Indians. They perform all the normal functions of a bank and thus help the internal trade of the country but take no part in the external trade. Their practices are still far from satisfactory. They are advised to increase their cash balances and to consolidate rather than extend the existing business.

✓ **Foreign Exchange Banks.** They have head quarters in foreign countries and are not registered in India. They finance the foreign trade of the country by purchasing and discounting foreign bills of exchange, by making advances against shipping documents and by issuing foreign letters of credit. Because they are financed and officered by non-Indians, the Central Banking Inquiry Committee suggested that they should be required to take out a license and should undertake to train Indians for executive posts. An All-India Foreign Exchange Bank to be started with the help of the Government was also suggested by them.

Although the existing banks have made steady progress,

they continue to keep alarmingly low cash balances. It is high time that they were compelled by law to maintain a fixed higher percentage of their total deposits in India and not to disturb it in spite of what may happen outside.

**The Presidency Banks.** They were private institutions. In the beginning they were financed by the Government (and hence allowed to issue notes) but after 1861 they were gradually deprived of official patronage except in that they occasionally served as Government bankers. They did not possess sufficient funds of their own nor was there any co-ordination between them. They were thus incompetent to finance the growing trade of the country and after some hesitation were amalgamated into the Imperial Bank in 1921.

✓ **The Imperial Bank.** It was started with a capital of Rs. 11½ crores. In addition to the functions of an ordinary joint stock bank, it acted as banker to other banks and to the Government of India. It was not allowed to deal in foreign exchange. During its 20 years of successful career, it has rendered useful service to the country. It has extended banking facilities and put the idle balances of the Government at the disposal of trade and commerce of the country. Nevertheless, the bank has come in for a good deal of criticism on account of its free use of Government funds and predominantly non-Indian management.

✓ **Co-operative Banks.** They owe their existence to a desire on the part of the Government to prevent the agriculturists from the exploitation of the money-lender. They lend money at low rates of interest and have great educative value. The village or town banks are called primary societies. They are financed partly from within and partly by the Central Banks which are themselves financed by the Provincial Banks. The Co-operative Movement has only touched the fringe of the credit problem of India and the indigenous bankers continue to be the principal source of finance for rural population. The Reserve Bank has recently made numerous suggestions for the improvement of the co-operative movement.

**Land Mortgage Banks.** Their object is to lend money for long periods for productive operations and to enable agriculturists to redeem their mortgaged property. These banks require more efficient management than the ordinary banks and when started on co-operative basis they rely on outside experts and Government assistance. The existing Land Mortgage Banks

of India are mostly of the quasi-co-operative type and they have not proved very helpful so far.

↯ **Post Office Savings Banks.** They aim at inculcating habits of banking and thrift among middle classes by receiving deposits, by issuing cash certificates and by offering insurance policies to Government servants. In order to prevent the progress of these banks from being inconveniently brisk, certain restrictions have been imposed as to the amount that an individual can deposit but experience does not justify these restrictions. Post Office Savings Banks are still few and far between and they ought to be extended to the areas which are not accessible to other institutions.

**Deficiencies of the Indian Money Market.** The development of the money market is not commensurate with the size and resources of the country. There is one bank to every 1,774 square miles and to every 329,598 heads of population. The deposit per man is also incredibly low, namely, Rs. 6. This compares very unfavourably with other countries of Europe and even with other members of the British Empire. Special credit agencies like Industrial Banks are conspicuous by their absence and the commercial banks frequently undertake tasks for which they are ill-fitted. Agriculture is still dependent on the mercy of the disinterested *sahukar* who is only interested in fleecing his clients alive. Branch banking is still in its infancy and is more useful to the urban than to rural areas. The functions of currency and credit were, till lately, vested in opposite directions. Poor cash balances, restricted use of cheques, want of co-ordination between the different members of the money market, instability of money rates, and absence of re-discounting facilities are some of the other defects of the money market which threw in relief the immediate necessity of establishing a Central Bank in the country.

↯ **Meaning of a Central Bank** A Central Bank has been described as "the people's agency to govern their supply of currency and credit free from any undue influence of politics or profits". It is entrusted with the right of note-issue; the right to hold the reserve of other banks; the right to buy and sell securities; and the right of discount with the help of which it can control and coordinate the functions and activities of the different members of the money market. It acts as a Bankers' Bank and also as banker to the Government of the country.

**A State or Share-holders' Bank.** The Hilton Young Commission had recommended a Central Bank for India in

the person of the Reserve Bank but the bill authorising it aroused great controversy especially on the point as to whether it should be a State or a Share-holders' bank. Those who favoured the State control of the Bank urged that in a country full of illiterate people a Government bank will inspire greater confidence than a private institution. A bank can also be rid of profiteers by handing control to the Government and can be used as an instrument for creating additional currency in times of grave national emergencies. Those who favoured a share-holders' bank feared that the Government may misuse its privileges and continuity of policy may not be secured with changes in party politics. Considering that the activities of the Government of India are generally regarded with suspicion, a private bank was preferred to a State bank. Anyhow, the Bill was dropped and a comprehensive banking enquiry was ordered.

The banking Enquiry Committee recommended the establishment of the Reserve Bank and made valuable suggestions for financing the external trade, for improving the bill market, for regulating banking and for disseminating banking education. These recommendations were ultimately incorporated in the Reserve Bank Act of 1934.

✓ **The Reserve Bank Act** The Bank has been started with a capital of Rs. 5 crores divided into shares of Rs. 100 each and subscribed by people from different provinces. The general superintendence has been vested in a Central Board of Directors consisting of 16 directors including one Governor and two Deputy Governors who are whole-time paid officials. The Board will be advised by five Local Boards—one for each area—in matters relating to their respective areas. The Bank has been authorised to receive deposits without interest, re-discount bills, purchase and sell gold and sterling, give loans to governments and banks against approved securities accept articles for safe custody, act as agent to the Government of India and other Native States and to issue bank notes. It has not been allowed to engage in trade, purchase its own shares or shares of other commercial and industrial concerns, give loans against mortgaged property or to give interest on deposits. Every scheduled bank is required to maintain a fixed proportion of its deposits with the Reserve Bank. Armed with these powers and privileges, the Bank will be able to control and regulate banking in India and render invaluable assistance to trade and industry and more particularly to agriculture

**Rural Finance and the Reserve Bank.** Unlike a trader or a manufacturer, an agriculturist cannot borrow money cheaply partly because the security against which he borrows is uncertain and partly because he does not satisfy the conditions on which the modern banks are prepared to accommodate him. Even the Reserve Bank has refused to deal with him except through intermediate agencies like the indigenous money lenders and the cooperative societies provided these agencies are prepared to re-organise themselves according to the suggestions made to them through the Agricultural credit Department.

**Reserve Bank in Action.** The Bank has succeeded in reducing and stabilising money rates and in offering cheap remittance facilities. It has also helped Government to raise loans and to reform banking legislation. The bank has, however, not yet succeeded in establishing better contact between the indigenous bankers and the other members of the money market. Nor has it yet developed a regular bill market. It also failed to save the Travancore National and Quillon Bank from failure. Suggestions have also been made for the improvement of administration and for removing those defects of the Reserve Bank Act which have been revealed within the last six or seven years.

**Effect of the Present War on Banking in India.** The banks have stood the strain of War very well indeed. The total deposits have increased although the time liabilities have gone down a bit which is not surprising considering that the people are anxious to keep their money as liquid as possible. The banks have also rendered adequate assistance to trade and industry. This is clear from the figures of advances and bills discounted as well as from the statistics relating to bankers' advances with the Reserve Bank.

**Industrial Finance.** Industrial development is necessary both for its own sake as well as for the purpose of stimulating agricultural improvements and for remedying unemployment. But it has not been possible to start many industries in India for want of adequate financial facilities, especially long-term credit facilities. Some people seem to believe that industries can only be helped by specialised institutions but the experience of foreign countries shows that this is wrong. The ordinary commercial banks can prove very useful especially if they combine into syndicates. Special Industrial Banks may also be necessary, especially to finance small scale industries. Such banks should be started privately but the Government must insure them against possible losses.

The Indian Companies Act of 1913 and 1936. The Indian Companies Act as amended in 1936 defines a banking company as one whose 'principal' business is to accept deposit on current account or otherwise, subject to withdrawal by cheque, draft or order. Such companies are required to keep as cash reserve  $1\frac{1}{2}$  per cent of their time liabilities and 5 per cent of their demand liabilities. They are also required to carry 20 per cent of their annual profits to the reserve fund until such fund is equal to their paid-up capital. The Act also recognises the legal status of scheduled banks.

**Banking Legislation.** For the purpose of controlling banking business and to ensure its orderly development the Reserve Bank has formulated a comprehensive scheme for the consideration of the Government. When passed into an Act it is bound to safeguard the interest of depositors and generally in putting banking on a sound footing.

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### QUESTIONS

1. What is the difference between a modern bank and an indigenous banker? Enumerate all kinds of business that the latter transacts. [U.P. Inter. 1931].

2. An indigenous banker has been described by some as a 'Shylock' and a 'blood-sucker' and by others as the friend of the people. With which of the two views do you agree? Give reasons for your answer. [Delhi Inter. 1934].

3. Indicate the place of Exchange Banks in the Indian Banking System and describe the nature of the work which they perform. [Punjab B.A. 1928].

4. Enumerate the causes of the amalgamation of the Presidency Banks into the Imperial Bank of India. [Delhi Inter. 1930].

5. Discuss the relative importance of the indigenous bankers, joint stock banks and the Imperial Bank in the banking economy of the country. [U.P. Inter. 1932].

6. What are the chief functions performed by banks working in India? What reforms would you suggest for promoting banking development in the country?

[Agra B.A. 1932 and 1934; Delhi Inter. 1934].



7. Distinguish indigenous, co-operative and joint stock banks from one another so as to bring out their peculiar features in relation to aims, constitution and working.

[Punjab B.A. 1929].

8. India is said to be backward in the matter of banking facilities. Explain this statement and account for the backwardness.

[Delhi B.A. 1931 and Inter. 1932].

9. What are the principal functions of a Central Bank? On what lines should such a bank be established in India?

[Agra B.A. 1935].

10. Discuss the advantages of a Central Bank for India. How far, do you think, would the Reserve Bank of India be able to discharge those functions?

11. Discuss the arguments for and against a State Bank for India.

[Delhi Inter. 1929].

12. Compare and contrast carefully the functions of a Central Bank with those of an ordinary (joint stock) commercial bank. To what degree does the Imperial Bank of India fulfil the functions of a Central Bank?

13. Give a brief summary of the Reserve Bank of India Act, 1934.

14. Write brief explanatory notes on :—

(a) Sahukari and Sharafi System. [U.P. Inter. 1932].

(b) Co-operative Banks.

(c) Postal Savings Banks.

(d) Land Mortgage Banks.

[Agra B.A. 1934].

15. What are the special features of agricultural finance? Why are the ordinary joint stock banks unable to make adequate provision for such finance in India? Is the presence of the Reserve Bank likely to make any difference?

[Agra B. Com. 1941].

16. How are industrial concerns usually financed in India? In what way do these facilities fall short of what they are in European countries? What changes in the banking structure would you suggest to promote industrial development in this country?

[Agra B. Com. 1940].

